Supreme Court, U.S.
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No.

In the Supreme Court of the United States

JOHN LARSON AND ROBERT PFAFF,

Petitioners,

v.

THE UNITED STATES OF AMERICA,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

PETITION FOR WRIT OF CERTIORARI

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QUESTIONS PRESENTED

Petitioners were convicted of tax evasion for their role in the background mechanics of a tax-minimization strategy. The government's theory was that the transactions involved fail the judicially-created "economic substance" doctrine. Petitioners did not give anyone tax advice, and did not prepare or review any investor's returns but their own.

Under this Court's precedents, a tax evasion conviction requires a "voluntary, intentional violation of a known legal duty." *Cheek v. United States*, 498 U.S. 192, 201 (1991). At the time of the conduct at issue (and still today), the requirements of the economic substance doctrine and its application to criminal prosecutions were objectively unclear and therefore unknowable. And the federal tax evasion statute, 26 U.S.C. §7201, had never been interpreted to permit conviction for the alleged evasion of *others'* taxes, where the defendant was so far removed from the relevant taxpayers' returns.

The Second Circuit's affirmance of these convictions presents two questions meriting review:

1. Whether a defendant can be guilty of voluntarily and intentionally violating a known legal duty when the governing law is objectively unclear.

2. Whether for ten of the twelve counts of conviction petitioners' conduct was too remote from the taxpayers' returns to be charged under 26 U.S.C. §7201.

PARTIES TO THIS PROCEEDING

In addition to the parties shown in the caption, Raymond J. Ruble (also known as "R.J." Ruble) was a defendant-appellant below. He is filing a separate petition for certiorari.

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OPINION BELOW

The Second Circuit's opinion (App.1a-10a) is not reported.

JURISDICTION

The Second Circuit denied rehearing on November 22, 2010. Petitioners invoke this Court's jurisdiction under 28 U.S.C. §1254(1).

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

26 U.S.C. §§7201, 7206(2), and the Due Process Clause of the Fifth Amendment are reproduced at App.15a-17a.

STATEMENT OF THE CASE

The Second Circuit has called this "the largest criminal tax case in American history," *Stein v. KPMG, LLP*, 486 F.3d 753, 756 (2d Cir. 2007), and has recognized that it was "based on a fairly novel theory of criminal liability," *United States v. Stein*, 541 F.3d 130, 157 (2d Cir. 2008). It is the culmination of an unprecedented campaign by federal prosecutors to intimidate the accounting industry and the tax bar into abandoning tax-planning strategies that previously were understood to be aggressive, and debatable as a civil matter, but not remotely criminal. It also presents an excellent opportunity for this Court to resolve a longstanding conflict over the relevance of legal ambiguity in criminal tax prosecutions—a conflict that the United States itself previously recognized and asked this Court to resolve—and an important and recurring question concerning the reach of the criminal tax evasion statute. Review is warranted.

Factual Background

Petitioners John Larson and Robert Pfaff were tax professionals for nearly twenty years. While at KPMG, they helped develop tax-minimization strategies similar to those commonly used by all of the major accounting firms at the time. A4480-81, A1536.[1] Larson and Pfaff left KPMG in 1997 to form an investment advisory firm, Presidio Advisors. A233/¶13.

At Presidio, Larson and Pfaff worked closely with KPMG to help execute the mechanics of the "Bond Link Issued Premium Structure" ("BLIPS") transactions. BLIPS was a complex structure in which investors contributed capital to an entity that then took out a "premium" loan (one with an above-market interest rate) and received cash from the lender reflecting the above-market rate. Those proceeds, and the investor's initial capital, were contributed to an investment entity that entered into forward contracts to sell large quantities of foreign currency—usually the Argentinean peso or Hong Kong dollar, which were "pegged" to the dollar with a fixed exchange rate. If market forces compelled Argentina or Hong Kong to "break" their fixed exchange rate during the term of the forward contract, the BLIPS investor would have made a lot of money. A3900-06, A1675. Several pegs had broken in the 1990s, leading to fast, massive currency devaluations: Mexico (45%), Venezuela (35%), Thailand (50%), Malaysia (37%), South Korea (40%), Indonesia (85%), and Russia (50%). A4298-99. The tax benefits derived from the taxpayer's ability to count

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[1] "A" refers to the Joint Appendix of Defendants-Appellants filed in the Second Circuit.

the premium loan proceeds toward his or her "basis" in the investment partnership.

BLIPS was vetted in a months-long, intensive process, as tax experts inside and outside KPMG (including former IRS officials) debated it. Partners in KPMG's Washington National Tax group ("WNT"), who had ultimate responsibility for approving BLIPS, debated various aspects of the transaction, including its potential profitability. *See, e.g.*, A4269. Mark Watson, a highly skeptical member of WNT, grilled Presidio partner Amir Makov on the likelihood of the peg devaluing in a 60-day period. App.60a-63a. Makov explained that the chance of devaluation within 60 days could not be predicted with any precision, but if it happened investors would realize a 400-500% return on their investment. *Id.*; A2272/3587. Ultimately KPMG settled upon a version of the transaction for which the firm could issue a "more likely than not" opinion. A1823/2127. That opinion was contingent on the individual taxpayers' written factual representations that they had independently reviewed the economics of the transaction. *E.g.*, A3605, A3613, A3908.

KPMG identified the clients and explained the potential tax advantages. Presidio helped explain the investment potential, set up the appropriate entities, arrange the bank loans, and execute the currency forward contracts. A1649. The taxpayer-investors consulted numerous independent financial and tax advisors, including leading national law firms, and Presidio provided these advisors access to whatever information they requested about BLIPS. *E.g.*, A1476/744-46; A1543/1009-10; A1546/1021; A3182. Larson and Pfaff did not give anyone tax advice, and did not prepare or review any investor's returns but

their own. Larson met only a few of the taxpayers; Pfaff never even communicated with any of them. *See infra*, 28-29 n.9.

In late 2000, the IRS issued Notice 2000-44, which was critical of certain structures similar to BLIPS and threatened to disallow deductions and impose civil penalties. *See Notice 2000-44*, 2000-2 C.B. 255. KPMG informed all of its clients of Notice 2000-44 and counseled them to seek further tax advice before taking any deduction based on BLIPS. App.36a-38a. The Department of Justice thereafter opened an investigation into the tax-minimization practices of the major accounting firms. *See United States v. Stein*, 435 F. Supp. 2d 330, 338-39 (S.D.N.Y. 2006).

Rather than litigating the merits of these transactions in civil proceedings as usual, federal prosecutors "[came] down on [the tax professionals] as if they belonged to the mob." Editorial, *KPMG in Wonderland*, Wall St. J., Oct. 6, 2005, at A14. Most of the major accounting firms quickly accepted fines and cooperated to avoid indictment. No professional firm has ever survived a criminal indictment, and Arthur Andersen had recently been destroyed by an indictment charging a theory of criminality that this Court later unanimously rejected. *Arthur Andersen LLP v. United States*, 544 U.S. 696, 698 (2005).

KPMG initially resisted, and announced that "'[a]ny present or former members of the firm asked to appear will be represented by competent coun[sel] *at the firm's expense*.'" *Stein*, 541 F.3d at 137. After the United States Attorney's Office told the firm that assisting with legal defense fees was "not a sign of cooperation" and threatened indictment, *id.* at 138, KPMG abruptly cut off those "who refused to

cooperate or 'took the Fifth,'" *id.* at 137. The firm entered into a deferred prosecution agreement and paid a $456 million fine. *Id.* at 139; *see also* Lynnley Browning, *How an Accounting Firm Went from Resistance to Resignation*, N.Y. Times, Aug. 28, 2005.

District Court Proceedings

1. Prosecutors charged nineteen professionals involved in KPMG's tax practice.

All KPMG-related defendants moved to dismiss on the ground that the government violated the Constitution by coercing KPMG to fire and cut off any legal defense from employees that refused to "cooperate." The district court found that the prosecution's actions violated the Fifth and Sixth Amendments, and that prosecutors had been "economical with the truth" in denying the defendants' charges. *Stein*, 435 F. Supp. 2d at 381. The court recognized that the government's misconduct had tainted the entire investigation—that "prosecutors used KPMG to coerce interviews with KPMG personnel that the government could not coerce directly," "used its leverage over KPMG to induce KPMG to coerce proffers by certain defendants," and denied the indicted defendants the "means of defending themselves" in what the court acknowledged to be an unprecedentedly complex discovery process. *United States v. Stein*, 495 F. Supp. 2d 390, 414, 410, 414, 416-17 (S.D.N.Y. 2007). The court further held that the prosecution's "actions were not justified by any legitimate governmental interest" and that "[t]heir deliberate interference with the defendants' rights was outrageous and shocking in the constitutional sense because it was fundamentally at odds with two of our

most basic constitutional values—the right to counsel and the right to fair criminal proceedings." *Id.* at 414.

The district court held that dismissal was the only appropriate remedy for thirteen defendants but refused to dismiss Larson and Pfaff, arbitrarily finding that it was "less clear" that KPMG would have continued to pay their legal fees absent the government's misconduct, *id.* at 425-26, even though it was undisputed that KPMG *was* paying their fees in related civil proceedings (a factor the court found compelling for the dismissed thirteen, *id.* at 406-07), and the government had *conceded* that Larson and Pfaff were identically situated to dismissed defendant Ritchie. *See* Larson Br. §I (2d Cir. Sept. 11, 2009) ("Larson CA2 Br.").

The Second Circuit agreed that the prosecution "unjustifiably interfered with defendants' relationship with counsel and their ability to mount a defense, in violation of the Sixth Amendment," and affirmed the district court's dismissal order. 541 F.3d at 136.

Two other defendants entered into plea agreements. Four defendants went to trial: Larson, Pfaff, former KPMG tax partner David Greenberg, and an outside attorney, R.J. Ruble, who wrote opinion letters.

2. The government's theory was that BLIPS lacked "economic substance" because it was very unlikely that the foreign currencies would devalue during the 60 days that most investors remained in the transaction.

The defendants unsuccessfully moved to dismiss the indictment on the ground that the relevant law was too uncertain to support conviction as a matter of law. *See* Dkt.216 at 31-35; *see also* Dkt.466; Dkt.921 (arguing that government must prove "that BLIPS crossed a

bright line [by] establishing a knowable legal duty that defendants specifically intended to violate").

The prosecution's case rested principally on the testimony of former Presidio partner Amir Makov, who became the government's star cooperating witness after 39 counts (195 years of potential imprisonment) against him were reduced to one five-year count, with a stipulation that he could serve any time in his home country, Israel. A4175-84, A2236-37/3444-45.

Admittedly abandoning his sworn deposition testimony (*see* A2216-18), Makov testified that the defendants knew that BLIPS had "close to zero" chance of generating a profit in a 60-day period. App.66a. But Makov also testified that they knew the Argentine peg would break eventually, App.56a-57a, 40a-41a, and that no one could calculate the probabilities in any particular time period, App.47a-48a. He also testified that if the peg had broken, "[t]he client would have made a return far in excess of the amount of equity that the client contributed to the transaction," App.51a, and that "[g]iven a devaluation, there was no question of the profit potential," App.55a; *see also* App.53a. Makov made clear that in his view BLIPS involved, like an out-of-the-money option, App.42a-43a, "an extremely small chance of something happening, that if it happens, the type of return would be unreasonable, would be extremely large," App.52a-53a. Makov had engaged in similar forward contracts at his hedge fund before joining Presidio. A2131.

Even the government conceded that BLIPS investors, at a minimum, had some "possibility of making a profit." A2653. The counterparty banks in the BLIPS currency transactions—which stood to lose a lot of money if the peg broke—found the risk of de-

pegging to be substantial enough to make hedging investments as insurance. A2121-22. The Argentinean peso devalued substantially in June 2001—just over a year after the last BLIPS transaction. A1514, A3580, A3885.

3. Every prior criminal case in the Second Circuit had affirmed instructions charging the jury that a transaction lacks economic substance only if it involves "no market risk"—*i.e.*, no real economic consequences. *See United States v. Ingredient Tech. Corp.*, 698 F.2d 88 (2d Cir. 1983) ("no risk of loss or chance for gain"); *United States v. Atkins*, 869 F.2d 135 (2d Cir.) ("no market risk"), *cert. denied*, 493 U.S. 818 (1989); *United States v. Regan*, 937 F.2d 823, 828 (2d Cir. 1991) (same); *United States v. Manko*, 979 F.2d 900, 910 (2d Cir. 1992) ("a transaction lacks economic substance if it lacks a reasonable possibility of profit *and lacks market risk*") (emphasis added), *cert. denied*, 509 U.S. 903 (1993). The defendants requested instructions tracking that standard. A1845 ("no possibility of making a profit"); A1853-60.

The district court deferred ruling on which standard would govern until after the close of evidence. The court openly struggled with the "uncertainty among the circuits," App.68a, acknowledged that the jury would be asked "to apply concepts that challenge tax professors," App.75a, and characterized the "[t]he Second Circuit cases" as "confusing," App.76a. Paraphrasing from "a civil case," the court concluded that the test is whether "there was no *reasonable* prospect" or no "*reasonable* probability of a profit." App.76a-77a (emphases added).

Over the defendants' objections (App.75a, A2628/4542), the court instructed the jury that a

transaction lacks substance if "the relevant taxpayer had no business purpose for engaging in the transaction apart from creating the tax deduction, and ... there was no *reasonable* possibility that the transaction would result in a profit." App.85a, 88a-89a (emphasis added). "The word profit," the district court explained, "means a return in excess of the cost of the investment, disregarding entirely any tax benefits." App.85a. The court also gave the jury examples of how much profit potential an investor might consider reasonable—examples which effectively told the jury that BLIPS was not a reasonable investment. App.86a-87a, 74a, 75a-76a (objections); Pfaff Br. 18-19 (2d Cir. Sept. 11, 2009).

4. The district court denied the defendants' general motions for acquittal at the close of the government's case, A2530, and after all the evidence, Dkt.1423. Those motions argued (*inter alia*) that the defendants could not have "ascertain[ed] exactly what legal duty [they] allegedly willfully violated" and that their role was too far removed from the filing of any allegedly false return to be covered by §7201. Mem. Supp. J. Acquittal Under R.29 at 25-28 (Dkt.1385).

The jury acquitted on the *Klein* conspiracy that was the heart of the government's case, as well as on a number of substantive counts (including all non-BLIPS counts). Greenberg was acquitted on all counts. Ruble was convicted of 10 counts of tax evasion, and Larson and Pfaff were each convicted of 12 counts and sentenced to 10 and 8 years in prison, respectively.

Proceedings in the Second Circuit

Larson and Pfaff argued (*inter alia*) that the district court's "reasonable-possibility-of-profit" instruction conflicted with prior Second Circuit

precedent and with *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978), that BLIPS had substance under the prevailing "no market risk" standard, and that the law was too unclear for criminal conviction. They also argued that their conduct was too remote from the taxpayers' returns to constitute "evasion" under §7201. The government filed a 209-page responsive brief (the briefing neared 500 pages total), arguing (*inter alia*) that under Second Circuit precedent "willfulness" is purely subjective and does not require an objectively clear legal rule, and that there are no proximate causation limits on the reach of §7201.

On August 27, 2010, the Second Circuit issued a published opinion reducing Larson's fine. *United States v. Pfaff*, 619 F.3d 172 (2d Cir. 2010) (*per curiam*). The court simultaneously affirmed petitioners' convictions and sentences in a separate, unpublished, "Summary Order." App.1a-10a.

The Second Circuit acknowledged that its prior economic substance cases had approved instructions allowing a jury to convict only if the transaction involved "'no market risk'" (quoting *Atkins*, 869 F.2d at 140), but held that those decisions did not "state the outer limits of the economic substance doctrine." App.4a. The court concluded that the district court's instruction was "a correct statement of the law" "[o]n the facts of this case," *id.*, citing only a *civil* case decided more than half a century ago, *Goldstein v. Comm'r*, 364 F.2d 734, 740 (2d Cir. 1966).

The Second Circuit held that "[v]agueness of the law does not *ipso facto* negate a jury finding of willfulness," and that "'knowability,' except perhaps as probative of a defendant's subjective belief in the lawfulness of his conduct, is only relevant insofar as it

bears on constitutional vagueness." App.5a-6a. The court further held that the economic substance doctrine is not unconstitutionally vague, because "[i]t has been applied in criminal cases before, and (as discussed) is not unsettled in the way Appellants contend." App.6a.

The Second Circuit also rejected petitioners' argument that their conduct was too remote from the taxpayers to fall within §7201's prohibition, noting that "[n]o case ... appears to have adopted any limit to its reach." App.7a. It was enough, the court concluded, that petitioners allegedly "involved themselves, with the requisite intent, in a scheme to avoid taxes." *Id.*

The defendants' timely petitions for rehearing and rehearing *en banc* were denied. App.11a-14a.

REASONS FOR GRANTING THE WRIT

The history of this case suggests that the nation's High Court should scrutinize these convictions with great care. These convictions were the product of one of the most notorious federal criminal investigations in the nation's history. Prosecutors used a novel and controversial interpretation of the criminal law to threaten the major accounting firms with indictment and the fate of their former competitor Arthur Andersen. Knowing that the firms could not risk litigating these issues, the government coerced them to pay hundreds of millions of dollars in fines and accept severe limitations on their tax planning practices. Prosecutors then unconstitutionally strong-armed KPMG into cutting off any assistance to individual employees that attempted to assert their rights. That campaign transformed the practice of law and accounting in this country. If the Second Circuit's decision is incorrect, and these defendants are actually innocent, then all of that was an injustice on the scale of

what happened to Arthur Andersen. This Court has reviewed the merits of other prosecutions that were based on novel theories of criminality and had substantial real-world consequences—such as *Arthur Andersen* and last Term's "honest services" cases. This case merits review for similar reasons.

This case also presents two questions that merit review under this Court's customary criteria. First, it presents an opportunity to resolve a longstanding conflict—recognized by the United States itself—about whether a criminal defendant can intentionally violate a known legal duty when the law is, objectively, unknowable. Although the case produced no majority opinion, five justices agreed in *James v. United States*, 366 U.S. 213 (1961), that a "willful" tax violation is impossible when the law is objectively unclear, *regardless of the defendant's subjective state of mind.* This Court recently embraced that principle *unanimously* in *Safeco Ins. Co. v. Burr*, 551 U.S. 47, 70 n. 20 (2007). But the Second Circuit and several others nonetheless hold that "'knowability,' except perhaps as probative of a defendant's subjective belief in the lawfulness of his conduct, is only relevant insofar as it bears on constitutional vagueness." App.5a-6a. That position directly conflicts with *Safeco* and with other circuits that hold that if the law was "'highly debatable, [the] defendant—actually or imputedly—lacks the requisite intent to violate it.'" *E.g.*, *United States v. Mallas*, 762 F.2d 361, 363-4 (4th Cir. 1985).

Those circuits would have rejected the novel and far-reaching theory of criminal liability underlying the indictments here. Whether the tax shelters at issue in this case had "economic substance" was and remains highly debatable. Many independent professionals reached the conclusion that these transactions would,

"more likely than not," be respected—and the *only* court that has ever considered their validity in a civil context ultimately held that no civil penalties could be imposed because the taxpayers objectively had "substantial authority" for their position. *Klamath Strategic Inv. Fund, LLC v. United States*, 472 F. Supp. 2d 885, 900 (E.D. Tex. 2007), *aff'd in part*, 568 F.3d 537 (5th Cir. 2009). Yet Petitioners are now serving decade-long sentences in a federal penitentiary for participating in those same transactions.

Second, Larson and Pfaff were too remote from the taxpayers' returns to be convicted under 26 U.S.C. §7201, which is the "capstone" felony under the Code and intended to punish only "the gravest of offenses against the revenues." *Spies v. United States*, 317 U.S. 492, 497, 499 (1943). The Second Circuit's concededly "expansive" reading of §7201, App.7a, annihilates the distinctions Congress carefully drew among tax crimes. At a minimum, it works "a startling innovation" in criminal tax liability that both aggravates the core vagueness problem in this case and independently warrants this Court's careful scrutiny. *Cheek v. United States*, 498 U.S. 192, 208 (1991) (Scalia, J., concurring).

The petition should be granted.

I. REVIEW IS WARRANTED TO RESOLVE CONFLICT OVER WHETHER LEGAL AMBIGUITY PRECLUDES CONVICTION OF CRIMINAL TAX EVASION

A. The Lower Courts Are Divided Over Whether Objective Legal Ambiguity Is Inconsistent With Willfulness

In *James*, this Court reviewed convictions for tax evasion where the underlying tax obligations were unsettled and debatable. A three-justice plurality

concluded that there was an underpayment but that the convictions must be reversed because "willfulness" could "not be proven in a criminal prosecution" where there was objective uncertainty about what the law required, regardless of the defendant's subjective state of mind. 366 U.S. at 221-22 (plurality op. of Warren, C.J.). Justices Black and Douglas thought no tax was owed, but agreed with the plurality that in any event the defendants were entitled to acquittal because of the ambiguity. *Id.* at 224 (Black, J., concurring in part and dissenting in part). Three other justices would have remanded for a new trial. *See id.* at 241 (Clark, J., concurring in part and dissenting in part); *id.* (Harlan, J., concurring in part and dissenting in part). In their view, "willfulness" turned on the defendants' *subjective* understanding of what the law had been. *Id.* at 243-44.

James has produced an intractable circuit split concerning whether objective uncertainty precludes willful intent. The United States has recognized this conflict and urged this Court to resolve it. *See* U.S. Pet. for Cert., No. 83-1297, *United States v. Dahlstrom*, at 15-19, *cert. denied*, 466 U.S. 980 (1984) (discussing "square[] conflict[]" over whether "'uncertainty in the law negates willfulness'" under *James*); *see also, e.g.*, John A. Townsend, *Tax Obstructions Crimes: Is Making IRS's Job Harder Enough?*, 9 Hous. Bus. & Tax L.J. 260, 265-70 (2009) (discussing circuit split and arguing that willfulness has objective and subjective components); Colleen S. Yamaguchi, Note, *Uncertainty in the Law: An Uncertain Defense in Criminal Tax Prosecutions*, 39 Tax Law. 387, 392-98 (1986) (recognizing split); Ian Comisky *et al.*, 1 *Tax Fraud & Evasion: Offenses, Trials, Civil Penalties* ¶2.03[3][d] (2010) (describing the "substantial body of case law

[that] has developed concerning whether the uncertain or unsettled nature of the law may be probative of or relevant to the issue of willfulness in a criminal tax case").

The courts that reject the *James* rule acknowledge that objective uncertainty might be relevant to *constitutional* vagueness, even if it is irrelevant to statutory willfulness. But that difference is important. The courts that apply *James* as a statutory matter undertake a rigorous and individualized evaluation of whether the defendant had objectively "reasonable" or "plausible" support for his tax position. It is not clear from existing precedent whether due process vagueness doctrine would be as strict—and as a practical matter the courts that reject *James* give the constitutional issue perfunctory, if any, attention. Many courts also have suggested that a jury finding of subjective bad faith may ameliorate constitutional "fair notice" concerns. *See, e.g.*, *United States v. MacKenzie*, 777 F.2d 811, 816 (2d Cir. 1985); *Poole v. Wood*, 45 F.3d 246, 249 (8th Cir. 1995); *Comm. in Solidarity with People of El Salvador v. FBI*, 770 F.2d 468, 476 (5th Cir. 1985); *see also Skilling v. United States*, 130 S. Ct. 2896, 2933 (2010) (noting that "the statute's *mens rea* requirement further blunts any notice concern"). The United States took that position in *Dahlstrom*. U.S. *Dahlstrom* Pet. 11-12 & n.10 (arguing that subjective scienter eliminates any due process issue). That may not be correct,[2] but there is no reason to reach difficult

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[2] This Court has indicated that "the more important aspect of the vagueness doctrine is not actual notice, but the requirement that a legislature establish minimal guidelines to govern law enforcement." *Kolender v. Lawson*, 461 U.S. 352, 357 (1983).

constitutional questions that can be avoided so easily on statutory grounds.

1. Four Circuits Have Held That Tax Convictions Require An Objectively Knowable Duty

Consistent with the views of five justices in *James*, the Fourth, Seventh, Ninth, and Eleventh Circuits hold that objective uncertainty precludes a finding of willfulness for criminal tax offenses. These indictments would have been dismissed in those circuits.

Fourth Circuit. In a series of cases beginning with *United States v. Critzer*, 498 F.2d 1160, 1163-64 (4th Cir. 1974), the Fourth Circuit has rejected tax convictions when the proper interpretation of the Code is objectively debatable. *Mallas* involved a tax shelter program that the IRS attacked in part on economic substance grounds. The transaction involved a mostly circular flow of funds, and was promoted as allowing investors to "receive $3.50 of [tax] deduction for every $1.00 invested." 762 F.2d at 362. Citing *James*, Judge Wilkinson explained that "[w]illful conduct under §7206, which the Supreme Court described in *United States v. Pomponio* as 'voluntary intentional violation of a known duty,' 429 U.S. 10 [(1976)] requires that the duty involved must be knowable." *Id.* at 363. The court explained that when "[g]rave penalties rest ... on an unsubstantiated theory of tax law," *id.*, and "the prosecution and the defense can ... both offer plausible support for their positions," *id.* at 364, "'the appropriate vehicle to decide this pioneering interpretation of tax liability is the *civil* procedure of administrative assessment,' not a criminal prosecution," *id.* at 365.

Seventh Circuit. *United States v. Harris*, 942 F.2d 1125 (7th Cir. 1991), was a criminal prosecution involving the distinction between gifts and income, which (like economic substance) is inherently subjective and uncertain as applied in difficult cases. Citing this Court's decisions in *James* and *Cheek*, the Seventh Circuit held that "[i]n the tax area, 'willful' wrongdoing means the 'voluntary, intentional violation of a known'—*and therefore knowable*—'legal duty.'" *Id.* at 1131-32 & n.6 (emphasis added). It reversed the conviction, concluding that when "the obligation to pay a tax is sufficiently in doubt" "willfulness is impossible as a matter of law, and the 'defendant's actual intent is irrelevant.'" *Id.* at 1132 (citing *United States v. Garber*, 607 F.2d 92, 98 (5th Cir. 1979) (en banc)). "[N]ew points of tax law may not be the basis of criminal convictions." *Id.* at 1131.

Ninth Circuit. In *United States v. Dahlstrom*, the Ninth Circuit considered a promoted tax shelter that the government insisted had "no economic substance" and constituted a "blatant sham[]." 713 F.2d 1423, 1427 (9th Cir. 1983), *cert. denied*, 466 U.S. 980 (1984). But the government "ha[d] not pointed to any cases which invalidated" the claimed tax treatment, and the Ninth Circuit rejected the government's reliance on a civil case that "was not decided until some ten months after these appellants had been convicted." *Id.* Finding "confusion" in the "application of substance over form in criminal prosecutions," the court held that if the relevant tax law is unsettled, "'a defendant—actually or imputedly—lacks the requisite intent to violate it.'" *Id.* at 1428 (quoting *Critzer*). The defendants lacked "willfulness" as a matter of law, even though they continued to promote their shelter after the IRS issued

an adverse position paper, because the law was "unsettled by any clearly relevant precedent." *Id.*

Eleventh Circuit. In *United States v. Heller*, the defendant was convicted of willfully evading taxes under §7201 for using a "case-closed method of accounting." 830 F.2d 150, 154-55 (11th Cir. 1987). Citing *James*, the Eleventh Circuit concluded that because a single civil case from 1965 had approved of that method, it was "inappropriate to impose criminal liability" "as a matter of law" on a defendant that had followed it or intended to follow it. *Id.* at 155 (quoting *Critzer*).

2. Three Other Circuits Have Held That Objective Uncertainty In The Law Does Not Preclude Conviction For Tax Crimes

By contrast, the Second, Fifth, and Sixth Circuits treat "willfulness" as a purely subjective issue.

Second Circuit. The decision below has its roots in *United States v. Ingredient Technology Corp.*, 698 F.2d 88 (2d Cir. 1983), in which the Second Circuit held that objective ambiguity is "irrelevant to willfulness issues" because it "sheds no light on defendant's intent." *Id.* at 97. The United States's petition for certiorari in *Dahlstrom* recognized (at 15) that *Dahlstrom* "squarely conflicts with *Ingredient Technology*."

Relying on *James* and a more recent circuit decision, *United States v. Pirro*, 212 F.3d 86 (2d Cir. 2000), Larson and Pfaff argued below for the *Critzer* rule. The United States argued that there was no majority opinion in *Pirro*, that *Ingredient Technology* remains circuit precedent, and that objective uncertainty in the law is completely irrelevant. *See* Gov't Br.106-09 (2d Cir. Jan. 15, 2010) ("Gov't CA2

Br.") (acknowledging circuit split and stating that defendants' *James* argument is foreclosed by *Ingredient Technology*).

The Second Circuit's order embraces the United States's reading of the circuit precedent, holding that "[v]agueness of the law does not *ipso facto* negate a jury finding of willfulness," because "'knowability,' except perhaps as probative of a defendant's subjective belief in the lawfulness of his conduct, is only relevant insofar as it bears on constitutional vagueness." App.5a-6a (citing *Ingredient Technology*).

Fifth Circuit. In *United States v. Garber*, the Fifth Circuit cited *Critzer* with approval in holding that objective uncertainty is relevant to willfulness, and that "the relevance of a dispute in the law does not depend on whether the defendant actually knew of the conflict." 607 F.2d at 98. *Garber* involved a challenge to the exclusion of evidence, and was widely criticized as essentially permitting *the jury* to evaluate whether the law was objectively clear. *E.g.*, Joshua Stein, *Criminal Liability for Willful Evasion of an Uncertain Tax*, 81 Colum. L. Rev. 1348, 1360 (1981).

Five years later, the Fifth Circuit limited *Garber* to its facts and held that objective legal uncertainty is "of marginal relevance" "apart from those few cases where the legal duty pointed to is so uncertain as to approach the level of [constitutional] vagueness." *United States v. Burton*, 737 F.2d 439, 444 (5th Cir. 1984).

Sixth Circuit. Explicitly rejecting the reasoning of *James*, and agreeing with the Second Circuit's decision in *Ingredient Technology*, the Sixth Circuit has held that "[w]illfulness is personal" and, therefore, only "'factual evidence of the defendants' state of mind'" can "'negate willfulness under any theory.'" *United States*

v. Curtis, 782 F.2d 593, 599 (6th Cir. 1986) (quoting *Ingredient Technology*).

B. The Second Circuit's Decision Is Inconsistent With *Safeco*

In a civil case, *Safeco v. Burr*, this Court recently held that a defendant does not act "willfully" if his conduct is consistent with an objectively reasonable understanding of the law, *regardless of subjective intent*. The Second Circuit's decision cannot be reconciled with *Safeco*.

Safeco involved an allegation that Safeco "'willfully' failed to comply" with requirements of the Fair Credit Reporting Act. 551 U.S. at 56. This Court interpreted "willfully" to require only civil recklessness—reckless disregard for, not actual knowledge of, the law. *Id.* at 56-60. This Court held that Safeco could not be reckless as a matter of law because "Safeco's reading of the statute, albeit erroneous, was not objectively unreasonable." *Id.* at 69. It rejected as "unsound" the "argu[ment] that evidence of subjective bad faith can support a willfulness finding even when" the defendant conformed its behavior to an "objectively reasonable" reading of the statute. *Id.* at 70 n.20. A finding of willfulness, this Court explained, must be based on an objectively unambiguous legal duty, because "it would defy history and current thinking to treat a defendant who merely adopts one [reasonable] interpretation [of the law] as a knowing or reckless violator." *Id.* "Congress could not have intended such a result for those who followed an interpretation that could reasonably have found support in the courts," this

Court concluded, "whatever their subjective intent may have been." *Id.*[3]

If a defendant cannot act recklessly or knowingly for purposes of civil penalties when the law is objectively unclear, *id.*, then he certainly cannot form *Cheek* willfulness—the highest *mens rea* requirement known to the law—in a criminal case. In *Cheek* this Court made the subjective aspect of willfulness more stringent, by acknowledging a defense for unreasonable but honest mistakes of law, but gave no indication that it intended to reject the separate principle that a "known legal duty" must be objectively *knowable*. 498 U.S. at 201-03.

C. The Economic Substance of BLIPS Was At Least Reasonably Debatable

This case presents an ideal vehicle for resolving the circuit conflict, because this prosecution rested on the notoriously vague "economic substance" doctrine.

A fully informed and objectively reasonable lawyer could have concluded in 1999 and 2000 that BLIPS had "economic substance." Many did. Commentators argued that these defendants "had no reason whatsoever to think that under these circumstances they could face anything worse than the usual civil penalties," and that "the notion that their behavior is criminal, and even sufficiently criminal to threaten the very existence of [KPMG] and its thousands of jobs, casts doubt on the fairness and judgment with which the federal prosecutors have exercised their

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[3] *See also In re Seagate Tech. LLC*, 497 F.3d 1360, 1371 (Fed. Cir. 2007) (en banc) (citing *Safeco* and holding that "willful infringement" requires proof of both subjective intent *and* "objectively high likelihood" that conduct infringed valid patent).

discretion." Robert Weisberg & David Mills, *A Very Strange Indictment*, Wall St. J., Oct. 12, 2005, at A16; *see also, e.g.*, Lynnley Browning, *KPMG Defendants' Unity Starts to Fray at the Edges*, N.Y. Times, June 30, 2006 ("[T]he KPMG case, one of the largest criminal prosecutions ever, is not a straightforward fraud case. Hinging in large part on the complicated and vague tax code, the case is dauntingly complex, and no court has ever ruled the tax shelters in question illegal."); Patricia Hsue, Comment, *Lessons from* United States v. Stein*: Is the Line Between Criminal and Civil Sanctions for Illegal Tax Shelters a Dot?*, 102 Nw. U.L. Rev. 903, 907-08 (2008) ("The governing civil standards are uncertain and ambiguous at best," and "the government is inappropriately seeking criminal penalties"). And in the only civil case that has been litigated concerning BLIPS, the district court held that no civil penalties could be imposed because the taxpayers had "substantial authority" for their position. *Klamath*, 472 F. Supp. 2d at 901.[4] ""The substantial authority standard is an objective standard

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[4] *Klamath* held that the transaction lacked substance, but only because it concluded that the premium loan could be severed from the currency trading. 568 F.3d at 545; 472 F. Supp. 2d at 895. The trial court in this case rejected that approach, the government acquiesced, and it was not even submitted to the jury here. The district court correctly instructed the jury to "focus ... on the strategy as a whole," App.90a, and repeatedly directed its attention to the profitability of the currency-trading aspects of BLIPS as the key issue for evaluating economic substance, App.89a. The government initially proposed different instructions but strategically declined to object to the instructions given on this point, App.79-80a, and conceded on appeal that it had waived the *Klamath* theory in this case. *See* Gov't CA2 Br. 127 n.*; Larson CA2 Br. 54 n.16.

involving an analysis of the law and application of the law to relevant facts.'" *Id.* at 900 (quoting Treas. Reg. §1.6662-4(d)(2)).

"Economic substance" is a notoriously murky doctrine derived from this Court's early precedents holding that a transaction's substance, rather than its form, should control tax treatment. The IRS has long asserted the power to disregard tax-motivated transactions, but this Court has insisted that "[t]he legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted" and that the issue always "is whether what was done, apart from the tax motive, was the thing which the statute intended." *Gregory v. Helvering*, 293 U.S. 465, 469 (1935). In *Frank Lyon*, the IRS and lower courts disregarded the taxpayer's ownership of a building because he retained only a "nominal" potential for pre-tax profit. *Frank Lyon Co. v. United States*, 536 F.2d 746, 753-54 (8th Cir. 1976). This Court reversed, holding that Lyon's ownership was "not a simple sham to be ignored," 435 U.S. at 580, despite his lack of financial upside, because his ownership had real economic consequences—chiefly downside risks, *id.* at 577, 582-84.

Despite the actual holding in *Frank Lyon*, the IRS has argued with some success in the lower courts that this Court's decision establishes a two-prong requirement of subjective "business purpose" and objective "economic substance." There is a robust conflict about whether those requirements are conjunctive, disjunctive, or a muddy balancing test—and over exactly what the "objective" prong means. *See* Yoram Keinan, *The Many Faces of the Economic*

Substance's Two-Prong Test: Time For Reconciliation?, 1 N.Y.U. J.L. & Bus. 371, 407-16 (2005) (discussing circuit conflict); Jeffrey Glickman & Clark Calhoun, *The "States" of the Federal Common Law Tax Doctrines*, 61 Tax Law. 1181, 1184 (2008) ("[F]ederal court opinions in recent years have provided little guidance as to when the doctrine is to be applied and what the actual test is.").

The "reasonable-possibility-of-profit" test appears in many cases, but many courts instead require only that the transaction have "any practical economic effects other than the creation of income tax losses" or some equivalent formulation.[5] The very summer that KPMG was internally debating the substance of BLIPS, the IRS filed a report with Congress recognizing that latter test as the "most prominent" test nationwide. Department of Treasury, *The Problem of Corporate Tax Shelters: Discussion, Analysis and Legislative Proposals* 159 n.494 (July 1999) ("*Treasury Rep.*"). And even the courts reciting a reasonable-possibility-of-profit test often set a very low threshold, finding economic substance so long as the chance of profit was not essentially zero.[6]

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[5] *Sochin v. Comm'r*, 843 F.2d 351, 354 (9th Cir. 1988); *see also, e.g., James v. Comm'r*, 899 F.2d 905, 908-09 (10th Cir. 1990); *Smith v. Comm'r*, 937 F.2d 1089, 1094 (6th Cir. 1991); *N. Ind. Pub. Serv. Co. v. Comm'r*, 115 F.3d 506, 512 (7th Cir. 1997) (transaction cannot be disregarded where it "result[s] in actual, non-tax-related changes in economic position").

[6] *See, e.g., Smith*, 937 F.2d at 1103, 1096, 1094 n.7 (transaction with a "'small chance for a large profit'" has substance); Kenneth W. Gideon, *Mrs. Gregory's Grandchildren: Judicial Restriction of Tax Shelters*, 5 Va. Tax Rev. 825, 838 (1986) ("A 'long shot' that will generate large rewards if successful has more than *de minimis* profit potential" and should be respected.).

The outcomes of these cases have been subjective and unpredictable, leading courts and commentators to describe the doctrine as little more than a judicial "smell test." *ACM P'Ship v. Comm'r*, 157 F.3d 231, 265 (3d Cir. 1998) (McKee, J., dissenting). The IRS's summer 1999 report to Congress confesses that "conflicting, incoherent decisions" under the economic substance and related doctrines "frustrate[]" the ability of taxpayers to predict or assess their own tax liabilities. *Treasury Rep.* 99. "Because the application of these common law standards is inherently subjective and courts have applied them unevenly, a great deal of uncertainty exists as to when and to what extent these standards apply, how they apply, and how taxpayers may rebut their assertions." *Id.* at 94; *see also, e.g.*, *Collins v. Comm'r*, 857 F.2d 1383, 1386 (9th Cir. 1988) ("Many [economic substance] tests proliferate because they give the comforting illusion of consistency and precision. They often obscure rather than clarify.").

It was at least objectively debatable in 1999 whether BLIPS had substance even under the "reasonable-possibility-of-profit" cases. *See Klamath*, 472 F. Supp. 2d at 895. A reasonable lawyer also could have concluded that "reasonable possibility of profit" is not the test—and that BLIPS plainly satisfies the "any-practical-economic-effects" test.[7]

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[7] The panel's order asserts that "[t]here is sufficient evidence that the transaction lacked any non-tax economic effect" because "[t]estimony described the chances of profiting from the investments as 'basically zero.'" App.5a. The government's star witness did say that, but at other points he testified that it was possible and depended on geopolitical events that no one could predict. *See* App.54a-55a. Regardless, the jury was not instructed to determine whether BLIPS involved "any non-tax economic

In the Second Circuit, particularly, the precedent was against any reasonable-possibility-of-profit requirement. There had been exactly four criminal economic substance cases in the Second Circuit before this one, and in each one the jury was instructed that a transaction lacks substance only if it entailed "*no* possibility of profit" or "lacked market risk." *Supra*, 8. Indeed, the government had argued that "subject to no market risk" was the criminal standard for economic substance in its brief to the Second Circuit in the *Manko* case in 1992. *See* U.S. *Manko* Br. (reproduced in Larson CA2 ADD. 5-6 n.*). Even in civil cases, the precedent overwhelmingly asked "'whether the transaction has any practicable effects other than the creation of income tax losses,'" *Jacobson v. Comm'r*, 915 F.2d 832, 837 (2d Cir. 1990), or "whether there has been a change in the economic interests of the relevant parties," *Rosenfeld v. Comm'r*, 706 F.2d 1277, 1282 (2d Cir. 1983).

The Second Circuit held here that "'reasonable possibility of profit'" was "[o]n the facts of this case ... a correct statement of the law" (App.4a), but cited only a 1966 civil case that does not even apply that standard and actually concludes that the transaction in question *was not* a "sham" but instead failed a statutory profit motive requirement. *Goldstein*, 364 F.2d at 737-38, 740 n.5, 742. The Second Circuit acknowledged that it "ha[d] in the past affirmed jury instructions stating a narrower definition" of economic substance than the one charged here, but stated that it "ha[d] not held that those instructions state the outer limits of the economic

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effect," so whether there was "sufficient evidence" under that standard is irrelevant. Defendants cannot be convicted by a court of appeals.

substance doctrine." App.4a. That reasoning effectively concedes that the standard was *at least* objectively unclear and debatable. How was a defendant to know, *unambiguously*, that the standard articulated in all of the cases and endorsed in the government's own prior briefing was not in fact the law?

The panel's suggestion that economic substance doctrine "has been applied in criminal cases before and (as discussed) is not unsettled in the way Appellants contend," App.6a, approaches absurdity. If the law was "settled" in the prior cases, it was settled in a manner wholly inconsistent with this prosecution. If anything, the law here was *more* unsettled than in many of the prominent circuit cases dismissing indictments where the governing law was objectively unclear—such as *Harris*, *Mallas*, and *Dahlstrom*.

II. THE SECOND CIRCUIT'S BOUNDLESS INTERPRETATION OF §7201 MERITS REVIEW

Section 7201 penalizes "[a]ny person who willfully attempt[s] in any manner to evade or defeat any tax...." The court of appeals held that §7201 is so "expansive" that it encompasses any "involve[ment]," no matter how remote or indirect, "with the requisite intent, in a scheme to avoid taxes." App.7a. That ruling renders the structure of the statute nonsensical, works an unprecedented expansion of the provision, and violates due process and the rule of lenity.

1. The criminal tax code is a "system of sanctions" that "provide[s] a penalty suitable to every degree of delinquency." *Spies*, 317 U.S. at 498. Section 7201 is the most serious offense, and carries with it the most severe penalties. Congress defined lesser crimes for

conduct that is more attenuated from a deficient tax return. 26 U.S.C. §7206(2), for example, prescribes a lesser penalty for "[a]ny person who ... [w]illfully aids or assists in, or procures, counsels, or advises" "in connection with" a materially fraudulent return. *See also id.* §7202.[8] The Second Circuit's "expansive" reading of §7201 would swallow these lesser penalties and render them superfluous. *See Ratzlaf v. United States*, 510 U.S. 135, 141 (1994).

Nor does the text suggest such a sweeping construction. The words that define the *actus reus* of the crime—"evade" and "defeat"—signify direct action and engagement. When Congress intends to impose principal liability upon persons further removed from the *actus reus*, it uses words that clearly reflect that intent—as it did, for example, in §7206(2).

2. The Second Circuit's interpretation also works a startling innovation that violates core principles of due process and lenity. *See United States v. Lanier*, 520 U.S. 259, 266 (1997). The Second Circuit observed that "[n]o case interpreting §7201 appears to have adopted any limit to its reach." App.7a. In fact, we are aware of no prior case in which the government had *attempted* to prosecute under §7201 a defendant as far removed from the relevant tax returns as Larson and Pfaff.[9]

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[8] *Compare* 26 U.S.C. §7201 (up to five years imprisonment and a fine of $100,000 (individuals) or $500,000 (entities) *with id.* §7202 (maximum fine $10,000); *id.* §7206 (maximum prison term three years).

[9] With respect to the ten KPMG-client counts of conviction, Petitioners were involved only in background mechanics. A3900-01; A3906; A1649/1433; A2165/3160; A1806/2057-60. They had no involvement in preparing or reviewing tax returns other than their own, or in communicating with the IRS.

Past prosecutions of tax-shelter "promoters" typically have charged violations of §7206(2), which expressly refers to indirect participation in a tax fraud.[10] And even the Solicitor General's petition in *Dahlstrom* (*see* pp.10-12) seemed to assume that remote actors could be prosecuted, if at all, only under §7206(2).

Every prior prosecution under §7201 (or its predecessors) of which we are aware involved taxpayer defendants or defendants engaged in conduct that was closely connected with the taxpayer or return—*e.g.*, corporate officers who prepared false tax returns or other forms on behalf of their companies;[11] tax preparers and advisers who conspired with

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A1565/1098. Petitioner Pfaff had no contact with *any* of the client-taxpayers whose taxes he was convicted of evading, A1601/1244; A2061/2857; A2063/2863-64; A2065/2871; A1757/1865; A1686/1580; A1538/991-92, and Larson discussed only the investment aspects of the transaction with the few investors he met, *e.g.*, A1666/1502. Petitioners *explicitly disclaimed* giving tax advice to any taxpayer. *E.g.*, A4306. The taxpayers relied upon people closer to them, including the tax experts at KPMG and Brown & Wood who issued the opinion letters. *E.g.*, A1460/683; A1476/746; A1823/2127; A4260; A4272-73. And the taxpayers specifically represented that they had *independently* reviewed the economics of BLIPS. *E.g.*, A3713; A3727; A3849; A3863; A3877; A3897; A4026; A4108. Most discussed these representations with their own tax advisors, such as tax attorneys at Gibson, Dunn & Crutcher. *E.g.*, A1476/744-46; A1543/1009-10.

[10] *See, e.g., United States v. Coveney*, 995 F.2d 578 (5th Cir. 1993); *Manko*, 979 F.2d 900; *United States v. Schmidt*, 935 F.2d 1440 (4th Cir. 1991); *United States v. Pacheco*, 912 F.2d 297 (9th Cir. 1990); *United States v. Oshatz*, 912 F.2d 534 (2d Cir. 1990); *Atkins*, 869 F.2d 135; *United States v. Kelley*, 864 F.2d 569 (7th Cir. 1989); *Mallas*, 762 F.2d 361; *Dahlstrom*, 713 F.2d 1423.

[11] *See, e.g., United States v. Troy*, 293 U.S. 58, 60-61(1934); *United States v. Townsend*, 31 F.3d 262, 267 (5th Cir. 1994); *United States v. Brill*, 270 F.2d 525, 526 (3d Cir. 1959).

taxpayers;[12] or defendants who stole money intended for the IRS.[13]

The Second Circuit's limitless construction—which extends to every conceivable contributing cause of a tax deficiency, however remote or indirect, and completely subsumes the lesser crime defined by §7206(2)—would encourage arbitrary and discriminatory charging decisions. *See Kolender*, 461 U.S. at 357-58 (legislature must "'establish minimal guidelines to govern law enforcement,'" to protect defendants from "'a standardless sweep [that] allows policemen, prosecutors, and juries to pursue their personal predilections'"); Gov't CA2 Br. 147 & n.* (arguing that §7201 authorizes the prosecution of "*unlimited*" potential targets).

To avoid these serious constitutional problems, the statute must be limited to "core" conduct—acts of evasion committed by people actually involved in the filing and/or payment of the tax. *See Skilling*, 130 S. Ct. at 2928.

III. THIS CASE PRESENTS ISSUES OF NATIONAL IMPORTANCE

The troubled history of the prosecution in this case underscores the need for careful consideration by this Court. The government has been widely criticized for using a highly aggressive and novel theory of criminal liability in this case to intimidate tax professionals and

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[12] *See, e.g., United States v. Wilson*, 118 F.3d 228, 231 (4th Cir. 1997); *Leathers v. United States*, 250 F.2d 159, 160-61 (9th Cir. 1957); *Tinkoff v. United States*, 86 F.2d 868, 875 (7th Cir. 1936).

[13] *See, e.g., United States v. Pesaturo*, 476 F.3d 60, 64 (1st Cir. 2007); *United States v. Wisenbaker*, 14 F.3d 1022, 1024 (5th Cir. 1994).

to extract massive fines from firms that could not risk litigating. *See, e.g.*, *KPMG in Wonderland*, Wall St. J., *supra* (The "KPMG trial [had] an Alice-in-Wonderland quality; the accused are on trial for promoting a fraudulent tax shelter that has never been proved to be fraudulent in the first place."); Reynolds Holding, *Accounting for Crime*, Time, Mar. 8, 2007 (describing defendants' ordeal as "a prosecutorial beating" that "happened before any court ruled the tax shelters improper"). The government built its case through coercive tactics that the courts below rightly condemned as unconstitutional and outrageous, requiring the dismissal of all charges against most of the defendants. Larson and Pfaff should have been dismissed too; instead they bore the concentrated brunt of the government's campaign, and are now serving lengthy sentences for conduct that hundreds of professionals nationwide concluded, on objectively reasonable grounds, was lawful.

The government's relentless campaign against these transactions ruined countless careers, destroyed at least one national law firm (Jenkins & Gilchrist, formerly 600 lawyers nationwide), and has dramatically chilled the legal and accounting professions from structuring transactions that capitalize on advantageous quirks in the Tax Code. (In addition to the $456 million fine, KPMG's deferred prosecution agreement expressly forbade them from having a private client tax practice or a compensations and

benefits tax practice *at all*, and prohibited the creation of pre-packaged tax products.[14])

This Court has been vigilant about reviewing other recent high-profile cases in which prosecutors have attempted to make new public policy via aggressive interpretations of the criminal law. *See, e.g.*, *Skilling*, 130 S. Ct. 2896; *Black v. United States*, 130 S. Ct. 2963 (2010); *Weyhrauch v. United States*, 130 S. Ct. 2971 (2010); *Arthur Anderson*, 544 U.S. 696 (2005); *cf. United States v. Goyal*, No. 08-10436, ---F.3d---, 2010 WL 5028896, at *9 (9th Cir. Dec. 10, 2010) (Kozinski, C.J., concurring) (citing "a string of recent cases in which courts have found that federal prosecutors overreached by trying to stretch criminal law beyond its proper bounds"). This case is at least as important and similarly cries out for this Court's intervention. *See* Lynnley Browning, *Judge Rejects Charges for 13 on Tax Shelter*, N.Y. Times, July 17, 2007 (likening the government's "aggressive legal tactics" here to *Arthur Andersen*).

The government's theory here also poses some of the same dangers of criminalizing legitimate professional advice that this Court saw in *Arthur Andersen*. *See* 544 U.S. at 703-04. In the Second Circuit's view, a lawyer or accountant can be convicted of willful tax evasion even if the law was debatable and unclear, if a jury finds evidence of *subjective* consciousness of wrongdoing. Even leaving aside the obvious risk of error in such findings, a lawyer's usual obligation is to pursue his client's interests within the

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[14] *See* KPMG Deferred Prosecution Agreement, *at* http://www.justice.gov/usao/nys/pressreleases/August05/kpmgdpagmt.pdf.

bounds of an *objectively* reasonable understanding of the law. *See Jerman v. Carlisle, McNellie, Rini, Kramer & Ulrich LPA*, 130 S. Ct. 1605, 1634 (2010) (Kennedy, J., joined by Alito, J., dissenting) ("When statutory provisions have not yet been interpreted in a definitive way, principled advocacy is to be prized, not punished. Surely this includes offering interpretations of a statute that are permissible, even if not yet settled."); *cf. Legal Servs. Corp. v. Velazquez*, 531 U.S. 533, 545 (2001) (law restricting arguments available to attorneys "prohibits speech and expression" and held unconstitutional). The lawyer's personal, subjective views about how a legal ambiguity ultimately should be resolved cannot be allowed to transform creative legal work into a crime. *See* ABA Comm. on Prof'l Ethics and Grievances, Formal Op. 280 (1949) (A lawyer "is not an umpire, but an advocate. He is under no duty to refrain from making every proper argument in support of any legal point because he is not convinced of its inherent soundness.... His personal belief in the soundness of his cause or of the authorities supporting it, is irrelevant.").

The United States asked this Court to review the nascent conflict between *Dahlstrom* and *Ingredient Technology*. Since then, the split has grown deeper and more important—and the appropriate resolution has become much more clear. These issues recur frequently in tax prosecutions, because (as this Court recognized in *Cheek*) tax law is uniquely unclear. And the law in the Second Circuit is particularly important, given its financial prominence and the particular zeal with which prosecutors in that circuit have pursued, and continue to pursue, tax prosecutions.

The "largest criminal tax case in American history," *Stein*, 486 F.3d at 756, should have merited a substantial published opinion grappling with the many important issues raised in 500 pages of appellate briefing (such as the relevance of this Court's decision in *Safeco*, which petitioners briefed extensively and the Second Circuit wholly ignored). Instead, the Second Circuit affirmed these convictions in a seven-page Summary Order. But this Court frequently reviews unpublished decisions when the issues are important and have been covered thoroughly in prior published opinions.[15] That practice serves the interests of justice. *See* Ruth Bader Ginsburg, *The Obligation to Reason Why*, 37 U. Fla. L. Rev. 205, 222 (1985) ("A limited publication rule, however sensible its purpose, is susceptible of misuse. What controls might a court install to inhibit resort to an unpublished, abbreviated disposition to conceal or avoid a troublesome issue?"); Jeffrey Cole & Elaine Bucklo, *A Life Well Lived: An Interview with Justice John Paul Stevens*, 32 Litig. 8, 67 (2006) ("I tend to vote to grant more on unpublished opinions, on the theory that occasionally judges will use the unpublished opinion as a device to reach a decision that might be a little hard to justify.").

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[15] *See, e.g.*, *Hardt v. Reliance Standard Life Ins. Co.*, 130 S. Ct. 2149 (2010); *Hertz Corp. v. Friend*, 130 S. Ct. 1181 (2010); *Boyle v. United States*, 129 S. Ct. 2237 (2009); *Flores-Figueroa v. United States*, 129 S. Ct. 1886 (2009); *Crawford v. Metropolitan Gov't of Nashville & Davidson County*, 129 S. Ct. 846 (2009).

CONCLUSION

The petition should be granted.

Respectfully submitted,

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UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

AMENDED SUMMARY ORDER

RULINGS BY SUMMARY ORDER DO NOT HAVE PRECEDENTIAL EFFECT. CITATION TO A SUMMARY ORDER FILED ON OR AFTER JANUARY 1, 2007, IS PERMITTED AND IS GOVERNED BY FEDERAL RULE OF APPELLATE PROCEDURE 32.1 AND THIS COURT'S LOCAL RULE 32.1.1. WHEN CITING A SUMMARY ORDER IN A DOCUMENT FILED WITH THIS COURT, A PARTY MUST CITE EITHER THE FEDERAL APPENDIX OR AN ELECTRONIC DATABASE (WITH THE NOTATION "SUMMARY ORDER"). A PARTY CITING A SUMMARY ORDER MUST SERVE A COPY OF IT ON ANY PARTY NOT REPRESENTED BY COUNSEL.

At a stated term of the United States Court of Appeals for the Second Circuit, held at the Daniel Patrick Moynihan United States Courthouse, 500 Pearl Street, in the City of New York, on the 26th day of October, two thousand ten.

PRESENT: DENNIS JACOBS,
Chief Judge,
RALPH K. WINTER,
JOSEPH M. McLAUGHLIN,
Circuit Judges.

- -X

United States of America,

Appellee,

-v.- 09-1702-cr (L)
09-1707-cr (CON)
09-1790-cr (CON)

Robert Pfaff, Raymond J. Ruble, also known as R.J. Ruble, John Larson,

Defendants-Appellants.

- -X

FOR APPELLANTS:

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FOR APPELLEE: JOHN M. HILLEBRECHT, Margaret Garnett, Justin Anderson, Katherine Polk Failla, Assistant United States Attorneys, of counsel, for Preet Bharara, United States Attorney for the Southern District of New York.

Appeal from a judgment of the United States District Court for the Southern District of New York (Kaplan, J.).

UPON DUE CONSIDERATION, IT IS HEREBY ORDERED, ADJUDGED AND DECREED that Appellants' convictions and Larson's term of imprisonment be **AFFIRMED.**

Raymond Ruble, Robert Pfaff, and John Larson appeal from judgments of conviction and a sentence entered April 15, April 21, and April 24, 2009, respectively, in the United States District Court for the Southern District of New York (Kaplan, J.). Appellants were convicted of tax evasion, and sentenced principally to terms of imprisonment and fines. In a separate per curiam opinion filed today, we decide the challenge to Larson's fine, imposed under 18 U.S.C. § 3571(d). We assume the parties' familiarity with the underlying facts and the case's procedural history.

Appellants raise five issues here: [1] whether the jury instructions were flawed; [2] whether the evidence was sufficient to support their convictions; [3] whether the government's case at trial constructively amended the indictment; [4] whether they are entitled to have

their indictments dismissed pursuant to United States v. Stein, 541 F.3d 130 (2d Cir. 2008); and [5] whether the district court erred in imposing Larson's sentence. The issues are considered seriatim.

[1] We find no error in the district court's jury instructions. "We review jury instructions de novo, and reverse only when the charge, viewed as a whole, constitutes prejudicial error." United States v. Amato, 540 F.3d 153, 164 (2d Cir. 2008). The district court charged the jury that a transaction lacks non-tax economic effect when there is "no reasonable possibility that the transaction would result in a profit." On the facts of this case (where the non-tax economic effect proffered by the defense was the possibility of profit), that was a correct statement of the law. See, e.g., Goldstein v. Commissioner, 364 F.2d 734, 740 (2d Cir. 1966) (disallowing "deduction for [transactions] that can not with reason be said to have purpose, substance, or utility apart from their anticipated tax consequences," in case where taxpayer could have realized a $22,875 profit given favorable market changes (emphasis added)). We have in the past affirmed jury instructions stating a narrower definition. See, e.g., United States v. Atkins, 869 F.2d 135, 140 (2d Cir. 1989) (approving instruction that transaction has no non-tax economic effect if it is "subject to no market risk"). But we have not held that those instructions state the outer limits of the economic substance doctrine. Nor do we find any error in the district court's circumstantial evidence examples, which were, if anything, favorable to the defense.

[2] The evidence was sufficient to support the convictions. When reviewing a conviction for sufficiency of evidentiary support, "the trial evidence is

viewed most favorably for the Government" and "all reasonable inferences a jury may have drawn favoring the Government must be credited." United States v. Wexler, 522 F.3d 194, 206-07 (2d Cir. 2008). We affirm "'if any rational trier of fact could have found the essential elements of [the] crime beyond a reasonable doubt.'" Id. at 207 (emphasis omitted) (quoting Jackson v. Virginia, 443 U.S. 307, 319 (1979)).

There is sufficient evidence that the transaction lacked any non-tax economic effect. Testimony described the chances of profiting from the investments as "basically zero."

Sufficient evidence also supports the jury's finding that the transactions were entirely motivated by tax purposes. Clients testified that the transactions were marketed solely as tax-avoidance schemes, and that, as clients, they had no non-tax business purpose in executing them. Evidently, that is why, at the outset of the purportedly seven-year scheme, a good number of BLIPS clients attempted to limit their commitment to sixty days, even though exiting so early would significantly limit their (already nugatory) chances of profiting on the currency forwards. BLIPS was designed, marketed, and executed as a tax shelter; and the jury was warranted in concluding that all parties knew BLIPS's profit potential to be nothing more than a pretext.

In a challenge to the finding of willfulness, Appellants argue that "economic substance" law was too vague to support their convictions. Citing United States v. Pirro, 212 F.3d 86, 91 (2d Cir. 2000), Appellants contend that economic substance law was not sufficiently "knowable." But "knowability," except perhaps as probative of a defendant's subjective belief

in the lawfulness of his conduct, is only relevant insofar as it bears on constitutional vagueness. Vagueness of the law does not ipso facto negate a jury finding of willfulness. See United States v. Ingredient Tech. Corp., 698 F.2d 88, 97 (2d Cir. 1983). And economic substance law is not unconstitutionally vague: It has been applied in criminal cases before, and (as discussed) is not unsettled in the way Appellants contend. Cf. Pirro, 212 F.3d at 91 (affirming partial dismissal of an indictment insofar as it charged a violation of a purported legal duty the existence of which was an open question).

In addition, sufficient evidence was presented to the jury to support its finding that Ruble either knew or consciously avoided knowing that the taxpayers lacked a non-tax business purpose for engaging in the transaction, and that there was no reasonable possibility that the transaction would yield a profit. As discussed above, Ruble was aware that the investors had no reasonable expectation of a profit unless they remained invested for the long term, and that most of the investors had exited the deals within sixty days. Moreover, the jury was free to infer that Ruble knew that the transaction had no business purpose based on his close relationship with Pfaff and Larson.

Finally, we disagree that Appellants' actions fall outside the ambit of the tax evasion statute, 26 U.S.C. § 7201. Section 7201 provides, in relevant part:

> Any person who willfully attempts in any manner to evade or defeat any tax imposed by this title or the payment thereof shall, in addition to other penalties provided by law, be guilty of a felony.

The statute's expansive language is not susceptible to a limitation that would exclude Appellants. No case interpreting § 7201 appears to have adopted any limit to its reach; those cases that have considered § 7201's scope have rather expressed it expansively, see, e.g., United States v. Townsend, 31 F.3d 262, 267 (5th Cir. 1994) ("[Section] 7201 is not limited to prosecutions of those who evade taxes that they may owe themselves, but rather it encompasses prosecutions of any person who attempts to evade the tax of anyone."). Appellants involved themselves, with the requisite intent, in a scheme to avoid taxes, and we see no statutory basis for excluding them from liability under § 7201.

[3] Appellants' argument concerning constructive amendment is reviewed de novo. United States v. Rigas, 490 F.3d 208, 225 (2d Cir. 2007). They argue that the government undertook to prove at trial a conspiracy of the Appellants *against* KPMG, rather than the charged conspiracy *with* KPMG. But Appellants were acquitted of conspiracy. Constructive amendment of the conspiracy charge would have warranted vacatur of that charge only; the remainder of the indictment would have stood. See United States v. Milstein, 401 F.3d 53, 64-66 (2d Cir. 2005) (per curiam) (vacating conviction on one count for constructive amendment of indictment with respect to that count, and rejecting argument that the constructive amendment warranted vacatur of convictions on other counts). Because no Appellant was convicted of conspiracy, we would be unable to afford relief even if we were to find error.

[4] The district court found that KPMG would not have paid Pfaff's and Larson's legal fees in this case, and that dismissal under our decision in Stein was

therefore unwarranted. We review this finding for clear error. Stein, 541 F.3d at 142, 146. Pfaff and Larson point to a number of facts that they claim demonstrate the clear error of the district court's finding, none persuasive. Most strongly emphasized are three pieces of evidence.

First is a 2004 statement by KPMG then-CEO Gene O'Kelly that "[a]ny present or former members of the firm asked to appear will be represented by competent coun[se]l at the firm's expense." United States v. Stein, 495 F. Supp. 2d 390, 407 (S.D.N.Y. 2007) (first emphasis added). But this statement speaks not at all to what conduct the promise covers, and is therefore of limited independent value. Pfaff and Larson note that some of their indicted conduct occurred while they were at KPMG; but that conduct was minimal relative to the indicted conduct after they left. There is no direct evidence that KPMG considered such a small proportion to be enough, and it was reasonable for the district court to infer in the circumstances that KPMG would not have paid Pfaff's and Larson's fees, given the incentives driving fee payment in the first place, see Stein, 541 F.3d at 144 ("[A] firm may have potent incentives to advance fees, such as the ability to recruit and retain skilled professionals in a profession fraught with legal risk.").

Second, Pfaff and Larson compare their situation to that of Gregg Richie, whose attorney's fees, the district court found, would have been paid by KPMG. However, in contrast to Pfaff and Larson, Ritchie had little involvement with BLIPS after leaving KPMG. Ritchie's relevant conduct post-KPMG appears to constitute only a small part of his involvement with BLIPS, as compared with his role as head of KPMG's

CaTs ("Capital Transaction Strategies") group—[t]he KPMG group focused on designing, marketing, and implementing tax shelters for individual clients."

Finally, Pfaff and Larson point to KPMG's payment of their legal fees in the Perez v. KPMG civil case, which they contend demonstrated KPMG's willingness to pay their legal fees in connection with legal proceedings arising from BLIPS. But the Perez case involved conduct undertaken entirely during Pfaff's and Larson's employment at KPMG, see Notice of Removal at 25-37, Perez v. KPMG, No. 7:03-cv-00026 (S.D. Tex. Jan. 24, 2003); and is therefore distinguishable on the lines discussed.

[5] Larson argues that his term of imprisonment is impermissibly longer than the sentences imposed on other defendants. We review sentencing decisions for "reasonableness," employing "the familiar abuse-of-discretion standard." Gall v. United States, 552 U.S. 38, 46 (2007). As Larson contends, the district court relied on the defendants' ages, observing that any lengthy sentence "would be a life sentence without parole for all these men." Since Larson is just 13 months younger than Pfaff, it would have been questionable to rely on this factor alone to justify a sentence disparity. But the district court stated that age was merely one of the factors justifying the difference. The district court properly relied on the fact that Larson moved assets abroad in order to protect them from creditors and from the government. See 18 U.S.C. § 3661 ("No limitation shall be placed on the information concerning the background, character, and conduct of a person convicted of an offense which a court of the United States may receive and consider for the purpose of imposing an appropriate sentence.").

In a separate per curiam opinion filed today, we decide the challenge to Larson's fine, imposed under 18 U.S.C. § 3571(d). Finding no merit in Appellants' remaining arguments, we accordingly **AFFIRM** Appellants' convictions and Larson's term of imprisonment.

FOR THE COURT:

CATHERINE O'HAGAN WOLFE,
CLERK

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

At a stated term of the United States Court of Appeals for the Second Circuit, held at the Daniel Patrick Moynihan United States Courthouse, 500 Pearl Street, in the City of New York, on the 22nd day of October, two thousand ten.

[UNITED STATES COURT OF APPEALS]
[FILED]
[NOV 22 2010]
[Catherine O'Hagan Wolfe, Clerk]
[SECOND CIRCUIT]

UNITED STATES OF AMERICA,

Appellee,

-v.-

09-1702-cr (L)
09-1707-cr (CON)
09-1790-cr (CON)

ROBERT PFAFF, RAYMOND J. RUBLE, also know as R.J. RUBLE, JOHN LARSON,

Defendants-Appellants.

Appellant John Larson having filed a petition for panel rehearing, or, in the alternative, for rehearing *en banc*, and the panel that determined the appeal having considered the request for panel rehearing, and the

active members of the Court having considered the request for rehearing *en banc*,

IT IS HEREBY ORDERED that the petition is denied.

FOR THE COURT:
Catherine O'Hagan Wolfe, Clerk

s/ Catherine O'Hagan Wolfe
[seal omitted]

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

At a stated term of the United States Court of Appeals for the Second Circuit, held at the Daniel Patrick Moynihan United States Courthouse, 500 Pearl Street, in the City of New York, on the 23rd day of October, two thousand ten.

[UNITED STATES COURT OF APPEALS]
[FILED]
[NOV 23 2010]
[Catherine O'Hagan Wolfe, Clerk]
[SECOND CIRCUIT]

UNITED STATES OF AMERICA,

Appellee,

-v.-

ROBERT PFAFF, RAYMOND J. RUBLE, also know [sic] as R.J. RUBLE, JOHN LARSON,

Defendants-Appellants.

AMENDED
09-1702-cr (L)
09-1707-cr (CON)
09-1790-cr (CON)

Appellants John Larson, Robert Pfaff and Raymond J. Ruble having filed a petition for panel rehearing, or, in the alternative, for rehearing *en banc*, and the panel that determined the appeal having considered the request for panel rehearing, and the active members of

the Court having considered the request for rehearing *en banc*,

IT IS HEREBY ORDERED that the petition is denied.

FOR THE COURT:
Catherine O'Hagan Wolfe, Clerk

s/ Catherine O'Hagan Wolfe
[seal omitted]

CONSTITUTION OF THE UNITED STATES

Amendment V

No person shall ... be deprived of life, liberty, or property, without due process of law ....

26 U.S.C. § 7201
TITLE 26. INTERNAL REVENUE CODE
SUBTITLE F. PROCEDURE AND ADMINISTRATION
CHAPTER 75. CRIMES, OTHER OFFENSES AND FORFEITURES
Subchapter A. Crimes
PART I. GENERAL PROVISIONS

§ 7201. Attempt to evade or defeat tax

Any person who willfully attempts in any manner to evade or defeat any tax imposed by this title or the payment thereof shall, in addition to other penalties provided by law, be guilty of a felony and, upon conviction thereof, shall be fined not more than $100,000 ($500,000 in the case of a corporation), or imprisoned not more than 5 years, or both, together with the costs of prosecution.

26 U.S.C. § 7206

TITLE 26. INTERNAL REVENUE CODE
SUBTITLE F. PROCEDURE AND ADMINISTRATION
CHAPTER 75. CRIMES, OTHER OFFENSES AND FORFEITURES
Subchapter A. Crimes
PART I. GENERAL PROVISIONS

§ 7206. Fraud and false statements

Any person who—

* * * *

(2) Aid or assistance

Willfully aids or assists in, or procures, counsels, or advises the preparation or presentation under, or in connection with any matter arising under, the internal revenue laws, of a return, affidavit, claim, or other document, which is fraudulent or is false as to any material matter, whether or not such falsity or fraud is with the knowledge or consent of the person authorized or required to present such return, affidavit, claim, or document; * * * *

KPMG

750 B Street
San Diego, CA 92101

Telephone 691 233 8000
Fax 619 696 0121

December 31, 1999

Pearl Ventures LLC
KS Revocable Trust
Mr. Kosti Shirvanian – Trustee
23 Corporate Plaza, Suite 247
Newport Beach, California 92660

You have requested our opinion regarding the U.S. federal income tax consequences of certain investment transactions that have been concluded by Pearl Ventures LLC ("Investor"), a Delaware single-member limited liability company. As more fully described below, Investor participated in a series of transactions involving investments in foreign currency-based securities and derivative contracts through an investment fund. The investment transactions were structured through an investment program (the "Investment Fund") designed by Presidio Growth LLC ("Presidio"). Presidio is an independent investment advisor registered under the Investment Advisers Act of 1940 that specializes in structured financial products and the execution of associated investment and derivative-based trading strategies.

* * *

C. Characterization of Debt Instrument

Investor entered into the $47,500,000 loan to partially fund its participation in the Investment Fund. As

discussed, the loan was a fixed rate debt instrument with a seven-year term and interest payable quarterly at a rate of 17.695 percent per annum. Investor subsequently contributed the loan proceeds subject to the loan to Partnership. Partnership then entered into a fixed-for-floating rate interest swap for a seven-year term to reduce its risks related to a change in interest rates.

Prior to the release of Treas. Reg. Section 1.1275-6, the integration of a debt instrument and a hedge was permitted only in limited situations,[72] and generally was considered to be a favorable result by taxpayers and commentators. On June 14, 1996, the Service released Final Regulations concerning debt instruments with original issue discount, contingent payment debt instruments, and the anti-abuse rule for OID.[73] The purpose of the Regulations under Treas. Reg. Section 1.1275-6 was to extend the integration treatment to financial instruments that perfectly hedge a qualifying debt instrument into a synthetic fixed or floating rate obligation. Although the integration rules are taxpayer elective, an anti-abuse rule allows the Service relatively broad powers to force integration.

1. Qualifying Debt Instruments and "Section 1.1275-6 Hedges"

Treas. Reg. Section 1.1275-6(a) applies to either issuers or holders of qualifying debt instruments. This Regulation provides for the integration of a qualifying debt instrument and "Section 1.1275-6 hedges" if

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[72] Examples included integration under Treas. Reg. Sections 1.988-5, 1.446-4, and 1.1221-2.

[73] T.D. 8674, 61 Fed. Reg. 30133 (June 14, 1996).

certain requirements are met and if the combined cash flows of the components are substantially equivalent to those of a fixed or variable rate debt instrument. The purpose of the Regulations is to "permit a more appropriate determination of the character and timing of income, deductions, gains or losses than would be permitted by separate treatment of the components."[74]

Treas. Reg. Section 1.1275-6(b)(4) provides that if its provisions apply to a qualifying debt instrument and hedge, the integrated transaction is deemed to create a synthetic debt instrument with the same cash flows as the combined cash flows of the qualifying debt instrument and hedge. This integrated instrument generally is subject to the Treas. Reg. Section 1.1275-6 Regulations rather than the rules to which each component of the transaction would be subject on a separate basis.

Under Treas. Reg. Section l.1275-6(b), a qualifying debt instrument is any debt instrument other than:

- A tax-exempt obligation as defined in Code Section 1275(a)(3);
- A debt instrument to which Code Section 1272(a)(2)(6) (pertaining to certain interests in or mortgages held by a REMIC, and certain other debt instruments with payments subject to acceleration) applies; or
- A debt instrument that is subject to Treas. Reg. Sections 1.483-4 or 1.1275-4(c) (pertaining to certain contingent payment debt instruments issued for non-publicly traded property).

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[74] Treas. Reg. Section 1.1275-6(a).

A Section 1.1275-6 hedge is any financial instrument if the combined cash flows of the financial instrument and the qualifying debt instrument permit the calculation of a yield to maturity under the principles of Code Section 1272, or the right to the combined cash flows would qualify under Treas. Reg. Section 1.1275-5 as a variable-rate debt instrument that pays interest at a floating rate or rates (except for the requirement that the interest payments be stated as interest). A financial instrument can be a Section 1.1275-6 hedge only if it is issued substantially contemporaneously with, and has the same maturity as, the qualifying debt instrument. In addition, a financial instrument that hedges currency risk is not a Section 1.1275-6 hedge.

For purposes of determining what constitutes a Section 1.1275-6 hedge, Treas. Reg. Section 1.1275-6(b)(3) defines a financial instrument as a spot, forward, or futures contract; an option; a notional principal contract; a debt instrument, or a similar instrument, or a combination or series of financial instruments. Stock is not a financial instrument for purposes of this Regulation.

2. Requirements for Integration by Taxpayer

A taxpayer may integrate a qualifying debt instrument and a Treas. Reg. Section 1.1275-6 hedge if the taxpayer meets all of the following requirements provided in Treas. Reg. Sections 1.1275-6(c)(1)(i) through (vii):

- The taxpayer must adequately satisfy the identification requirements of Treas. Reg. Section 1.1275-6(e) by entering and retaining as part of its

books and records information related to issuance and acquisition of the qualifying debt instrument and the Section 1.1275-6 hedge;

- None of the parties to the hedge may be related unless the related party uses a mark-to-market tax accounting method;
- Both the qualifying debt instrument and the Section 1.1275-6 hedge are entered into by the same individual, partnership, trust, estate, or corporation;
- If the taxpayer is a foreign person engaged in a U.S. trade or business, all items of income and expense associated with the integrated transaction (other than interest expense subject to Treas. Reg. Section 1.882-5) would, in the absence of the integration rules, be effectively connected income during the synthetic debt instrument's term;
- Within 30 days immediately preceding the issue date of the synthetic debt instrument, the taxpayer did not terminate, or "leg out"[75] of, an integrated transaction containing the qualifying debt instrument, any other debt instrument that is part of the same issue, or the Section 1.1275-6 hedge;
- The qualifying debt instrument must be issued on or before, or substantially contemporaneously with, the date of first payment on the Section 1.1275-6 hedge, regardless of whether the payment is made or received by the taxpayer; and

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[75] "Legging" into and out of integrated transactions is described in Treas. Reg. Sections 1.1275-6(d).

- The taxpayer cannot have entered into a straddle[76] prior to the issue date of the synthetic debt instrument containing the Section 1.1275-6 hedge or the qualifying debt instrument.

3. Integration by Commissioner

Even if a taxpayer does not integrate a qualifying debt instrument and a Treas. Reg. Section 1.1275-6 hedge, the Commissioner may do so if the combined cash flows on the qualifying debt instrument and financial instrument are substantially the same as the combined cash flows required for the financial instrument to be a Section 1.1275-6 hedge. Treas. Reg. Section 1.1275-6(c)(2) provides that the Commissioner may not integrate a transaction unless the qualifying debt instrument is subject to Treas. Reg. Section 1.1275-5 (related to "contingent payment debt instruments")[77] or Section 1.1275-5 (related to "variable rate debt instruments") and pays interest at an objective rate. Under Treas. Reg. Section 1.1275-5, a "variable rate debt instrument" is a debt instrument that meets all of the following conditions:

- The issue price of the debt instrument must not exceed the total noncontingent principal payments by more than an amount equal to the lesser of:
  - => .015 multiplied by the product of the total noncontingent principal payments and the

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[76] For this purpose, "straddle" is defined under Code Section 1092(c).

[77] A "contingent payment debt instrument" is defined under Treas. Reg. Section 1.1275-4 as any debt instrument that provides for one or more contingent payments.

number of complete years to maturity from the issue date, or

=> 15 percent of the total noncontingent principal payments.

- The debt instrument must only provide for stated interest (compounded or paid at least annually), at:
  - => one or more qualified floating rates,
  - => a single fixed rate and one or more qualified floating rates,
  - => a single objective rate, or
  - => a single fixed rate and a single objective rate that is qualified inverse floating rate.
- The debt instrument must provide that a qualified floating rate or objective rate in effect at anytime during the term of the instrument is set at a current value of that rate.
- The debt instrument must not provide for any contingent principal payments.

Because, under the facts in the instant case, the qualifying debt instrument is a fixed rate debt instrument, Treas. Reg. Section l.1275-6(c)(2) does not provide the Commissioner with authority to integrate the loan and interest rate swap. Furthermore, the inability of the Commissioner to integrate a hedge with a fixed rate debt instrument was specified in the preamble to the Final Regulations[78] concerning the anti-abuse rule for original issue discount, as follows:

Section 1.1275-6 INTEGRATION RULES:

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[78] T.D. 8674, 61 Fed. Reg. 30133 (June 14, 1996).

> Commentators generally approved of the integration rules in the proposed Regulations, and those rules are adopted with only two significant changes. First, the final Regulations allow (but do not require) the integration of a hedge with a fixed-rate debt instrument. For example, a taxpayer may integrate a fixed-rate debt instrument and a swap into a VRDI. Although the hedging transaction Regulations (Section 1.446-4) cover many of these transactions, the integration rules provide more certain treatment. The final Regulations, however, do not allow the Commissioner to integrate a hedge with either a fixed rate debt instrument or a VRDI that provides for interest at a qualified floating rate. In these cases, treating the hedge and the debt instrument separately is a longstanding rule that generally clearly reflects income.

Based upon the foregoing, we are of the opinion that it is more likely than not that the fixed-rate debt instrument and interest rate swap will not be integrated under Treas. Reg. Section 1.1275-6(c)(2).

D. Liquidation of Investor's Interest in Partnership: Basis in Distributed Property

On December 27, 1999, at the end of Stage I of the Investment Fund, Investor opted not to enter into Stage II of the investment program. As a consequence, Investor's interest in Partnership was liquidated on December 27, 1999.[79] Code Sections 731(a) and 731(b)

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[79] Partnership will not terminate as a result of the liquidation of Investor's Partnership interest. See Treas. Reg. Section 1.708-1

generally provide for both partner and partnership non-recognition treatment for liquidating distributions. However, a partner recognizes gain under Code Section 731(a)(1) to the extent that "money" distributed exceeds the partner's basis in its interest in the partnership. Losses are not recognized by a partner with respect to a liquidating distribution except as provided for in Code Section 731(a)(2). Treas. Reg. Section 1.731-1(a)(2) denies loss treatment if "any property" other than money, inventory, or unrealized receivables is distributed.

The liquidating distribution to Investor consisted of $643,966 in cash (money) and $56,691 in foreign currency. Code Section 731(c)(1)(A) defines "money" to include "marketable securities," and the term "marketable securities," is defined in Code Section 731(c)(2) as including foreign currency.[80] However, Code Section 731(c)(3) provides that the inclusion of

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(b)(1)(ii). Under Code Section 708(a), an existing partnership is considered as continuing if it is not terminated. Since there were two remaining partners, Presidio's two LLCs, there was no termination under Code Section 708(b)(1)(A). In addition, there was no "sale or exchange" of 50 percent or more of total partnership capital and profits as a result of the liquidation of Investor's Partnership interest because a liquidation is not considered a "sale or exchange" for purposes of Code Section 708(b)(1)(B). Treas. Reg. Section 1.708-1(b)(1)(ii).

[80] Pursuant to Code Section 731(c)(2)(A), marketable securities are financial instruments and foreign currency which are, as of the date of distribution, actively traded within the meaning of Code Section 1092(d)(1). Treas. Reg. Section 1.1092(d)-l(a) provides that actively traded personal property "includes any property for which there is an established financial market." "Financial instruments" include stocks and other equity interests, evidences of indebtedness, options, forward or future contracts, notional principal contracts, and derivatives.

marketable securities as money under Code Section 731(c)(1) shall not apply if the partnership is an "investment partnership" and each partner is an "eligible partner."

An "investment partnership" is defined in Code Section 731(c)(3)(C) as any partnership that is not engaged in a trade or business and substantially all of the assets of which have always consisted of money; corporate stocks; notes, bonds, or other evidences of indebtedness; foreign currencies; notional principal contracts; and interest in or derivative financial instruments in any of the listed assets. An "eligible partner" is any partner who has not contributed to the partnership any property other than the aforementioned.

Code Section 731(c)(3)(C)(ii) states that any activity undertaken as an investor, trader, or dealer in any of the listed assets is not a trade or business activity. Treas. Reg. Section 1731-2(e) further provides that a partnership is not engaged in a trade or business as a result of the receipt of commitment fees, break-up fees, guarantee fees, director's fees, or similar fees that are customary in and incidental to activities of a partnership as an investor, trader, or dealer. Accordingly, based upon the activities undertaken, Partnership is not engaged in a trade or business for purposes of applying the Code Section 73l(c) rules. The sole asset contributed by the members to Partnership was cash. Accordingly, each partner should qualify as an eligible partner for purposes of Code Section 731(c)(3)(C)(i) and Partnership is not engaged in a trade or business as defined in Code Section 731(c)(3)(C)(ii). The foreign currency, therefore, should not constitute money for purposes of Code Section

731(a). Consequently, because as discussed below, Investor's adjusted basis in its partnership interest exceeded the amount of cash distributed, Investor will recognize no gain with respect to the liquidating distribution.[81]

Upon a complete liquidation or a partner's partnership interest, Code Section 732(b) provides that the basis of any distributed property is equal to the partner's basis in its partnership interest immediately prior to the distribution, reduced by any actual cash received. Under Code Section 732(c), if the basis. of the distributee's partnership interest after reduction for any money received exceeds the partnership's basis in distributed unrealized receivables and inventory, each of these assets is allocated a basis equal to its basis to the partnership and the balance of the partner's basis in its partnership interest is allocated to other distributed assets as follows:

- First, each other distributed asset is provisionally assigned a basis equal to its pre-distribution partnership basis.
- If the provisional bases so assigned are less than the remaining basis to be allocated, the excess basis is allocated first to increase the bases of any appreciated assets so as to reduce all differences between values and bases proportionately, with any remaining excess basis allocated to all other distributed assets in proportion to their respective fair market values.

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[81] Because Investor's adjusted basis in its partnership interest exceeded the amount of all assets distributed in liquidation, there was no gain recognized in any event.

Accordingly, Investor's adjusted basis in its partnership interest is first reduced by actual cash received of $643,966 and the residual amount is allocated to the foreign currency distributed in accordance with the above methodology.

Since Investor contributed cash to Partnership, the initial basis to Investor of the partnership interest is the amount of money contributed; $77,995,000.[82] However, Investor contributed the $77,995,000 subject to a nonrecourse loan of $47,500,000. Code Section 752(b) provides that any decrease in a partner's individual liabilities by reason of assumption by the partnership of such liabilities shall be considered as a distribution of money to the partner by the partnership which, under Code Section 733, reduces the basis of the partner's partnership interest.[83] The basis of Investor's partnership interest is effectively the amount of the money contributed to the partnership reduced by the net liability relief (the difference between Investor's entire loan liability transferred to the partnership[84] and Investor's share of the liability as a partner, including Investor's share of liabilities contributed by other partners).[85] Treas. Reg. Section 1.752-3 provides that a partner's share of nonrecourse liabilities equals the sum of: (1) the partner's share of

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[82] Code Section 722 provides that the basis of an interest in a partnership acquired by a contribution of property, *including money*, to the partnership shall be the amount of such money and the adjusted basis of such property to the contributing partner at the time of the contribution increased by the amount of gain recognized under Section 721(b) to the contributing partner.

[83] Treas. Reg. Section 1.752-1(f).

[84] Code Section 752(b).

[85] Code Section 7 52(a).

the partnership's Code Section 704(b) taxable gain; (2) the partner's Code Section 704(c) minimum gain; and (3) the partner's share of the partnership's excess nonrecourse liabilities. Accordingly, Investor's basis of $77,995,000 from its cash contribution is reduced by the net amount of the Code Sections 752(a) and 752(b) adjustments.

Furthermore, all changes in Partnership "liabilities" result in constructive cash contributions and distributions. Upon the liquidation of Investor's Partnership interest, Investor's remaining share of partnership liabilities decreased to zero. Investor originally contributed a liability of $47,500,000 to Partnership, and was ultimately relieved of the entire liability. Furthermore, any increases in Investor's share of Partnership liabilities attributable to other loans of Partnership will have no net effect upon the redemption of Investor's Partnership interest, because a corresponding decrease in Partnership liabilities will result at such time. As a consequence, the total deemed cash distributions to Investor under Code Section 752(b) upon entering into the Partnership and the redemption of Investor's Partnership interest is $47,500,000, reducing its basis in its partnership interest to $30,495,000.[86]

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[86] Under Code Section 705(a)(2), a partner's basis is decreased (but not below zero) by the amount of cash distributed to him; the basis of any property distributed to him by the partnership; and his distributive share of partnership losses and nondeductible expenditures of the partnership not properly chargeable to capital account. Treas. Reg. Section 1.752-1(c) provides that any decrease in a partner's share of partnership liabilities is treated as a distribution of money by the partnership to that partner.

Upon liquidation of Investor's Partnership interest, we are of the opinion that it is more likely than not that Investor's adjusted basis amount of $30,495,000, plus or minus its allocable share of Partnership income or loss in its Partnership interest is first reduced by actual cash received of $643,966 and the residual amount is allocated to the foreign currency distributed.

* * *

Based on and subject to the facts, documentation and representations described and our discussion, and our analysis of the relevant statutory provisions and judicial doctrines, we believe that, under current U.S. income tax law, there is a greater than 50 percent likelihood (i.e., it is "more likely than not") that the following positions will be upheld if challenged by the Internal Revenue Service:

- The $28,500,000 loan premium will not constitute a liability of Investor or Partnership for purposes of Code Section 752, but represents an addition to the $47,500,000 loan to be amortized under Treas. Reg. Section 1.163-13 against the issuer's interest expense over the life of the loan;
- Investor will recognize no gain or loss upon receipt of the loan proceeds of $47,500,000, including the loan premium of $28,500,000;
- Investor will be recognized as the true borrower of the loan for U.S. federal income tax purposes;
- Investor will recognize no gain or loss with respect to its capital contribution of $77,995,000 to Partnership subject to the $47,500,000 loan;

- The fixed rate debt instrument and interest rate swap will not be integrated under Treas. Reg. Section 1.1275-6(c)(2);
- Upon liquidation of Investor's Partnership interest, Investor's adjusted basis of $30,495,000,[222] plus or minus its allocable share of Partnership income or loss in its Partnership interest is first reduced by actual cash received of $643,966 and the residual amount is allocated to the foreign currency distributed;
- The difference between the basis allocated to the foreign currency received in a liquidating distribution and the proceeds received upon disposition of such foreign currency will be deductible by Investor's sole member as an ordinary loss under Code Sections 165(a) and 988(a);
- Investor's sole member's Code Section 465 "at risk" amount for its taxable year ending on December 31, 1999, includes the cash and the adjusted basis of the assets distributed to Investor as liquidating distributions by Partnership;
- Partnership income (or loss) and the loss upon disposition of the assets received by Investor upon liquidation of its interest in Partnership will not be subject to limitation under the Code Section 469 passive activity loss rules;
- Investor's issuance of the debt instrument will not have a substantial effect on the issuer's U.S. income tax liability that could be construed as unreasonable

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[222] See Footnote 13.

in light of the purposes of Code Sections 163(e), 1271 through 1275, or 701-777.

Our conclusions are based on the completeness and accuracy of the above-stated facts, representations and assumptions. If any of the foregoing is not entirely complete or accurate, it is imperative that we be informed immediately, as the inaccuracy or incompleteness could have a material effect on our conclusions. We are relying upon the relevant provisions of the Internal Revenue Code of 1986 as amended, the regulations thereunder, and the judicial and administrative interpretations thereof, all as in effect as of the date of this letter. These authorities are subject to change or modification by subsequent legislative, regulatory, administrative, or judicial decisions. Any such changes also could have an effect on the validity of our conclusions. Unless separately engaged to do so in writing, we will not update our advice for subsequent changes or modifications to the law and regulations or to the judicial and administrative interpretations thereof.

Very truly yours,

s/KPMG LLP

KPMG LLP

PRESIDIO ADVISORY SERVICES, LLC
333 HAYES STREET, SUITE 200
SAN FRANCISCO, CA 94102

TELEPHONE (415) 284-7333
FACSIMILE (415) 264-72:64

June 30, 2000

Mr. Kenneth E. Jones
C/o Mr. John R. Comyns
Comyns, Smith, McCleary LLP
3470 Mt. Diablo Blvd., Suite A3l0
Lafayette, CA 94549

Dear Mr. Jones,

As you may be aware, the 60-day anniversary of your participation in the Olympus Strategic Investment Fund, LLC is July 17, 2000. As a reminder for you, we have summarized certain procedures that may be of interest.

Withdrawals are allowed on the 60th day after the initial contribution and on each subsequent 60-day anniversary.

Each withdrawing Class A member should copy and complete Annex A (Withdrawal Request) from their copy of the Amended and Restated Limited Liability Company Agreement. For convenience I have enclosed the Annex A with this letter.

At least 10 business days prior to the withdrawal, the Withdrawal Request should be faxed to the Fund c/o Steven Buss at Presidio Growth (415) 701-2555.

The original Withdrawal Request should be sent to the Fund c/o Presidio Growth LLC at 333 Hayes Street, Suite 200, San Francisco, CA 94102.

We also need some information to enable us to properly execute withdrawal requests that we may receive. Please complete the attached "Information Sheets" and fax them to me as soon as possible at (415) 701-2555.

Please call me if you have any questions.

Very truly yours,
s/Steven Buss
Steven Buss
Vice President

[attachments omitted]

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

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UNITED STATES OF AMERICA,

v. RS1 05 CR 888 (LAK)

JOHN LARSON,
ROBERT PFAFF,
RAYMOND J. RUBLE,
also known as "R.J. Ruble,"
and DAVID GREENBERG

Defendants.

----------x

New York, NY
October 17, 2008
9:45 a.m.

Before:

HON. LEWIS A. KAPLAN,
District Judge

* * *

[572]

[Maurice Marciano Cross Examination]

Q. And before you filed your tax return, you had a meeting with people from KPMG concerning Notice 2000-44. Do you recall that, Mr. Marciano? Does that ring a bell?

A. No. What's that?

Q. Before you filed –

A. Oh, yeah, the notice from the IRS.

Q. Yes.

A. Yes.

Q. Exactly.

A. Yes.

Q. Do you remember when that was, basically?

A. Either, either in late August or in September of 2000. Most likely September, I think.

Q. Could it have been October 4, may I just ask? And I can show you something to refresh your memory?

* * *

Q. Just look at that for one second to see if it refreshes your recollection, Mr. Marciano. Do you remember meeting with [573] members of KPMG on October 4, 2000, with you and your brother to discuss Notice 2000-44?

A. Yes.

Q. And after that meeting, one of the -- I'm sorry.

One of the things that you were told at that meeting was that you should get some additional advice before you filed your tax return. Right, Mr. Marciano?

A. I'm not sure. I'm not sure about that. I'm not sure that it was after that meeting. I think that there was another meeting with just George McCrimlisk, who told us about the IRS notification and in which he advised me to, because -- he advised me to get another, that it will be better to get another opinion from another law firm, that this will make the, you know, to give us more comfort.

Q. I may have been confusing then. So there may have been a meeting or a phone call with Mr. McCrimlisk more, right after Notice 2000-44?

A. That's correct.

Q. And before this meeting, is that right, sir?

A. That's what I think happened, yes.

Q. And do you remember you did hire a law firm, you and your brother did hire outside counsel to assist you in that evaluation, right?

A. That's correct.

* * *

Q. And after that, that is after you met with KPMG and visited with them some and after you had hired outside counsel, you then filed your tax return, correct, sir?

A. In October, on or before October 15, yes.

Q. And that is B533, and just so we have a sense of that, this is your tax return I'm showing, which is approximately about an inch and a half to two inches thick, right, Mr. Marciano?

A. It's like an encyclopedia.

Q. And when you filed that tax return and signed that under penalty of perjury, you didn't believe you were filing a false tax return, did you, Mr. Marciano?

A. No.

Q. And in connection with the filing and preparation of that return, you didn't talk to anyone from Presidio or seek their advice as to how to file a return, did you, sir?

A. No, not with Presidio.

* * *

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK
----------x

UNITED STATES OF AMERICA,

v. RS1 05 CR 888 (LAK)

JOHN LARSON,
ROBERT PFAFF,
RAYMOND J. RUBLE,
also known as "R.J. Ruble,"
and DAVID GREENBERG

Defendants.

----------x

New York, NY
October 29, 2008

* * *

[1540]

[Kerry Bratton Cross Examination]

Q. The sixth caret down, I'm sorry, fifth caret down, when you explained the use of forward contracts versus options, I'm not going to ask you to recite the difference now, but at the time are you confident you knew the difference and could explain the [1541] difference between a forward contract and an option?

A. I think at an initial level, yes, I would be able to, but, for a detailed explanation, I would have had to refer them to Amir.

Q. And that was your practice?

A. Yes.

Q. If you couldn't answer a question, you would give them somebody who could, right?

A. Yes.

Q. But you understood that if, when it talks about the most lost is the premium paid, that was in the event that the currency, say the Argentine peso actually went up in value against the U.S. dollar, that a forward would have a different effect than an option, correct?

A. Yes, yes.

Q. Then one of the questions you anticipated was why will the bank do the deal, and you see how you were prepared to respond to that. See that?

A. Yes.

Q. Did you or Mr. Larson or Mr. Makov in your presence -- and if you need to review that, you can -- ever suggest to an investor that loan proceeds would actually leave the custody of the bank in order to purchase the forward contracts?

A. No.

Q. Then with respect to the expected return, you told [1542] investors that it was impossible to predict when this event would happen, correct?

A. That's correct.

Q. You could just look at various indicators in other countries and try your hardest to analyze and make some kind of prediction, true?

A. That's true.

Q. And is it also true that Mr. Makov said in your presence more than once it was not a matter of if the peg would break, it was a matter of when the peg would break?

A. Yes. He said that quite often.

Q. That he was certain that the peg to Argentina would break?

A. Yes, he said that.

* * *

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK
----------x

UNITED STATES OF AMERICA,

v. RS1 05 CR 888 (LAK)

JOHN LARSON,
ROBERT PFAFF,
RAYMOND J. RUBLE,
also known as "R.J. Ruble,"
and DAVID GREENBERG

Defendants.
----------x

New York, NY
November 13, 2008

* * *

[3048]

[David Amir Makov Direct Examination]

Q. First of all, just to clarify, what you just said, is that something Mr. Larson said at the meeting or somebody else?

A. Mr. Larson.

Q. When you heard Mr. Larson say that, did you have any questions or suggestions for him?

[3049] A. Yes.

Q. Can you recall what you asked him or suggested to him?

A. Yes. I said, why don't we just take the 1 and a half million and buy what they call out-of-the-money options that have 5-to-1 payout.

Q. You're going to get used to this. Tell us what that means in simple terms, please.

A. Which one of the terms do you want me to explain?

Q. All three of them. Out-of-the-money options and the five times payout, what do those mean?

A. Option, I assume everybody knows what an option is.

Q. Don't make that assumption.

THE COURT: Don't assume anything.

A. An option is the right, but not the obligation, to do something in the future. For example, the world, let's say, of stocks. You could have an option to buy a stock at $100 for a year. In a year from now, you then have the right, but not the obligation, to exercise that right. So if the stock is worth more than $100 at that point in time, you will go ahead and exercise your option. If the stock is worth less than $100 at that point in time, you would not go ahead and exercise it because you lose money.

Now, because an option is valuable to the person who owns that option, the seller of the option will require a price or a fee for providing you with such an option. The fee in an [3050] option is typically called premium. Nothing to do with the premium on the loan. This happens to be the same word. But a price of an option is called what is the premium on the option. It is kind of like insurance. That is one way to look at an option. So that is what an option is.

An out-of-the-money option means the following. An option that is in the money means that already now today the intrinsic value of the option is already greater than the security that it is based upon, i.e., if you have the option to buy IBM shares or whatever it

is at $100, the shares today are trading around $100, that's kind of an option that is in the money because already we know what we are close to there.

An option that is out of the money would be the right to buy today the Dow Jones at 20,000. So yes, I could sell you the right to buy the Dow Jones at 20,000 even though it is around 8,000. That is a very out-of-the-money option because it is kind of worthless today because the likelihood of the Dow Jones being 20,000 in a year is fairly small.

Now, the more out of the money the option is, the bigger the payout will be if it happens. There is a smaller chance of it happening, but if it happens, you will get a lot of money. It is kind of like a lottery ticket. A lottery ticket is a good example of an out-of-the-money option.

Q. When you suggested the possibility of pursuing such options to Mr. Larson at this meeting, did he have any response to you?

[3051] A. Yes.

Q. What do you remember him saying about that?

A. He said an option won't work for tax purpose, for tax reasons.

Q. Did he tell you what he meant by that?

A. Yes.

Q. What did he say?

A. He said that we need to somehow be able to show a connection between the loan, which generates the tax loss, and the investment program that generates a possibility of making a profit.

Now, I forgot to mention earlier, with an option, the most you could lose on an option is the price you paid for it. So if we bought options, there will be no

theoretical argument to make to show that the loan was even used in any way, shape or form. So in fact, what John said we should be looking at is securities or assets that have an option-like payout but are not really an option. I believe at that meeting he already came up with an idea of trading or shorting pegged currencies to the dollar, that again have an option-like payout.

Q. Just again, define that for us, option-like payout. Very simply, what do you mean?

A. As I mentioned before, an owner of an option could only make money. Either you don't exercise it and nothing happens or an event happens and you make a lot of money. That is a [3052] payout of an option.

In a stock that you buy, you could either make money or lose money. The stock price goes down. So there are securities out there that their payout would be very similar to an option, meaning either nothing happens or something happens in which you make money.

THE COURT: This seems like a good point for our break.

(Jury excused)

(Witness excused)

(Recess)

* * *

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK
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UNITED STATES OF AMERICA,

v. RS1 05 CR 888 (LAK)

JOHN LARSON,
ROBERT PFAFF
RAYMOND J. RUBLE,
also known as "R.J. Ruble,"
and DAVID GREENBERG

Defendants.
----------x

New York, NY
November 14, 2008

* * *

[3102]

[David Amir Makov Direct Examination]

Q. Did you ever -- at this period of time, sir, '99 before BLIPS is approved, I am just going to focus you on that time frame -- did you ever get any instructions from either John Larson or Bob Pfaff about your own interactions with people at KPMG?

A. Yes.

Q. And what kind of instructions did you receive?

A. At first I received instructions from Bob Pfaff and then [3103] over time from John Larson.

The instructions were to be, you know, very careful with my communication with anyone at KPMG, to try to have any such communication go through John Larson, since KPMG has so many various different

divisions, I might not know who is a friendly party and who is not.

And, in fact, there was one name that came up in particular, it's Larry DeLap, if I would ever have a conversation with Larry DeLap the way I had the conversation on the phone call with Steve Rosenthal, that would put an end to Presidio-type products.

So they did anything in their power to make sure that I never meet Larry DeLap, I never communicate with him and I never be in the same room with Larry DeLap.

Q. Did they explain to you why they were concerned particularly about Larry DeLap?

A. Yes.

Q. Who said what to you about that?

A. Bob Pfaff said that Larry DeLap is like razor sharp, smart, honest. And if he knew there was any kind of monkey business or anything funny going on with BLIPS, what we were saying or representing, he could strike out BLIPS in one nano second, and there be no transaction.

* * *

[3143]

* * *

Q. Before I ask you about the specifics of the document, what was the process you went through crafting this document? How did you do that?

A. At first I had to come up with a mathematical model to determine or to estimate the probabilities if an event happened. The problem with coming up with a mathematical model to predict the probabilities of the devaluation has to do with the fact that you are

predicting something that never happened before. Typically when you do probabilities, you have an event that happens time and again, time and again, and you have this sampling process. In this case, well, what is the probability of something happening given it never happened in the past is very difficult to estimate.

* * *

[3150]

* * *

Q. In summary, can you recall what it is you told at that meeting KPMG that day?

A. Basically, pretty much what is written in the eight pager in which I explained there are emerging markets, there are pegged currencies, we are going to make bets against these pegged currencies, and, you know, if it so happens that a [3151] pegged currency happens to devalue during the investment program, investors would have, would make a cash-on-cash return.

Q. The eight pager, just so we're clear, if you can flip back to Tab 9, it is Government Exhibit B81.

A. A version of this.

Q. All right.

Were you asked any questions or did you have anything to say about your ability to turn a profit given the amount of money you were going to be using?

A. Yes. I mean, basically one of the people in the audience, in particular Mark Watson, figured out pretty quickly that what I'm asked to do is to create a 270 percent profit in 60 days. He was kind of questioning how realistic really is it to come up with an

investment program where people try, and typically do not succeed, to make 15 percent or 20 percent a year, yet here you have the task of making them a 300 percent in two months, how realistic is this investment program.

Q. When you say 270, 300 percent, just give us a more concrete way to explain what you are talking about.

A. Well, at the end of the day an investor contributes 7 cents, 7 dollars. Out of the 7 dollars, roughly 5 and a half go to pay fees. So you're left with 1 one and a half. So in order for an investor to make a cash-on-cash return, I need to turn this one and a half dollars into a number greater than 7.

[3152] So one and a half greater than 7, that is roughly 400 percent. So the investment program needs to generate a 400 percent return within 60 days in order to meet its goal of demonstrating a cash, the potential for a cash-on-cash return.

Q. When Mr. Watson asked you that question about how realistic that was, can you recall what you or anybody else said in response to his question?

A. Well, there was some back and forth between Mr. Watson and myself in terms of me not giving probability numbers and just saying, well, these are the events that actually happened and here are the countries that could happen, and him saying, you know, would any non-tax investor ever come in and invest in this program. It eventually got to the point of the discussion, that was kind of heated, where John Larson stood up and said, come on, guys, give Amir a break. We all know why we are here. We are here to get this product approved. He just explained to you the investment program and just leave it at that. Let's not play dumb over here.

Q. When the conversation was focusing on your contribution to the meeting, was there any discussion or questions asked in this meeting about the purpose for the premium loan structure?

A. No.

Q. And you mentioned something about would anyone do this investment for a non-tax reason. Was there anything further said about non-tax issues?

[3153] A. Not in that meeting in terms of finding a non-tax-driven investor to do this investment. Not in that meeting, but in subsequent meetings, yes.

* * *

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK
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UNITED STATES OF AMERICA,

v. RS1 05 CR 888 (LAK)

JOHN LARSON,
ROBERT PFAFF,
RAYMOND J. RUBLE,
also known as "R.J. Ruble,"
and DAVID GREENBERG

Defendants.
----------x

New York, NY
November 17, 2008

* * *

[3248]

[David Amir Makov Direct Examination]

Q. Just so we're clear, Mr. Makov, if the peg had actually broken on, let's say the Argentine peso during a 60-day period when a client was participating in their BLIPS, what would have happened?

A. The client would have made a return far in excess of the amount of equity that the client contributed to the transaction.

Q. But in this document, 496A, you are calculating the expected return. Is that correct?

A. I'm sorry. Are we still on the same document?

Q. Same one.

A. In this one I'm doing a probabilistic expectation of -- yes.

THE COURT: And it rests on a whole bunch of assumptions, right?

THE WITNESS: It rests on a whole bunch of assumptions.

THE COURT: And some of the assumptions at least are not empirically or objectively verifiable, right?

THE WITNESS: Yes, that's correct.

Q. If you could turn back to Tab 16, which is Government Exhibit 5000 in evidence. If you can focus down on the bottom portion of that document.

It says there, in part, that Hong Kong and/or Argentina are likely to devalue their currency in the future.

[3249] Was that a truthful representation of your belief in 1999?

A. Yes.

* * *

[3251]

* * *

Q. Did you communicate to Mr. Larson or Mr. Pfaff your view as to whether there was a reasonable opportunity for such a profit?

A. Yes.

Q. Once or more than once?

A. Many times.

Q. What was your view and what did you tell Mr. Pfaff and Mr. Larson?

A. That there was an unreasonable chance of making an unreasonable return.

Q. What do you mean by that?

[3252] A. That basically there is an extremely small chance of something happening, that if it happens the type of return would be unreasonable, would be extremely large. So there is an unreasonable chance of making an unreasonable return.

* * *

[3305]

* * *

Q. Now, during the meetings in which you participated, sir, did any of the prospective clients have any questions for you?

A. Yes.

Q. And in substance, what were some of the questions you were asked during the BLIPS presentations?

A. Yes, it varied a lot. Some of the clients had a genuine interest in the investment component. They found the subject matter interesting, the pegged currencies. Why the break, the fact, how much money would they actually make if a peg breaks. Some clients had this genuine interest.

Other clients simply referred to it as, oh, just like having a lottery ticket.

And some clients could care less. They just basically asked if we sign off today, that they want to get out on day 60, and some clients would ask me tax-related questions.

* * *

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK
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UNITED STATES OF AMERICA,

v. RS1 05 CR 888 (LAK)

JOHN LARSON,
ROBERT PFAFF,
RAYMOND J. RUBLE,
also known as "R.J. Ruble,"
and DAVID GREENBERG

Defendants.
----------x

New York, NY
November 18, 2008

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[3523]

* * *

[David Amir Makov Cross Examination]

Q. Take a look at tab 14, DXAB-1103.

MR. HAGEMANN: I offer it, your Honor.

MR. HILLEBRECHT: We don't have any objection, Judge.

THE COURT: Received.

(Defendant's Exhibit DXAB-1103 received in evidence)

Q. Now on the front we see an e-mail from you, and then just take a look at the second page if you would. If we could go to just the second page for a minute, Mr.

Makov. It says at the top "Venezuelan Bolivar." What were you attempting to convey to Mr. Larson here?

A. That when devaluation occurs, it occurs unexpectedly, and it occurs in a very large step. So you can see the pegged currency very -- moving -- the book is on the side. But then there will be a devaluation and you'll see like a step. And then again you try to peg the currency. Then again it gets devalued. And then somewhere around '96, you let it really float. So the difference between a floating currency and a [3524] pegged currency and how it could break several times.

Q. Are there two devaluations here on this chart?

A. This chart will show two significant devaluations. One, the little one at the beginning. And then two big ones. Around the time of, like, you know, early '96. And then again summer of '96.

Q. And so, just so we're clear, there was no question of the profit potential of a devaluation, right?

A. Given a devaluation, there was no question of the profit potential. That is correct.

Q. Tab 15, DXAB-1125 for identification. I offer it, your Honor.

MR. HILLEBRECHT: No objection, Judge.

THE COURT: Received.

(Defendant's Exhibit DXAB-1125 received in evidence)

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UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK
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UNITED STATES OF AMERICA,

v. RS1 05 CR 888 (LAK)

JOHN LARSON,
ROBERT PFAFF,
RAYMOND J. RUBLE,
also known as "R.J. Ruble,"
and DAVID GREENBERG

Defendants.
----------x

New York, NY
November 19, 2008

* * *

[3591]

* * *

Q: * * *

You never said that the peg would devalue, did you, sir?

A. I did say it would devalue, you know, over an infinite amount of time. At some point it would devalue, but I don't know when. I was quite sure that it will happen, I just could not predict when it will happen. And that's --

Q. You felt extremely confident, far more than more likely than not, that the peg would break within a couple of years or so, didn't you, sir?

A. I felt more confident about Argentina than Hong Kong, just because of the economic situation Argentina

was in, and I felt quite certain that there will be, there will come a point in time where Argentina will have to devalue its currency.

Q. But you of course couldn't know when or else you would be a billionaire today, correct, sir?

A. Correct, sir.

THE COURT: Let's take our break here.

* * *

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK
----------x

UNITED STATES OF AMERICA,

v. RS1 05 CR 888 (LAK)

JOHN LARSON,
ROBERT PFAFF,
RAYMOND J. RUBLE,
also known as "R.J. Ruble,"
and DAVID GREENBERG

Defendants.
----------x

New York, NY
November 20, 2008

* * *

[3766]

[David Amir Makov Cross Examination]

Q. Okay. Now, with respect to the Washington National Tax meeting, which you told us was shortly after the Beverly Wilshire meeting, you testified about that on November 14, and I think I heard you to say that from the Washington National Tax group in a room, were, among others, you, Mark Watson, Steve Rosenthal, am I right so far?

A. That is correct.

* * *

[3768]

* * *

There is a room, various tax professionals were asking me questions. Two of which were more skeptical, they kind of wanted to prove that the thing doesn't work.

Later on, I understood one of them was Mark Watson and one of them was Steve Rosenthal. The relationship between them, because they're like joking and passing notes and smiling to each other, implied to me that they knew each other. Because they were friendly to each other.

Q. Okay, so you remember that there were two heads with faces on them who were joking with each other, right?

A. There are lots of heads and faces. But two people who were the ones asking me the difficult questions, I later learned one of them was Mark Watson and one of them was Steve Rosenthal.

Q. All right, sir, and the person you now know to have been Mark Watson, was a person who grilled you on the question of profit potential, correct?

[3769] A. Not necessarily. They -- they both asked questions regarding that issue in various forms. And I think I testified, and went to do that again, as to the form of the questions that was asked.

Q. Mark Watson put before you, sir, that there would need to be a 270 percent rate of return on the peso for an investor to realize a profit, is that right, sir?

A. That document you are referring to is a document that I have seen in my preparation for trial several years later.

I don't think that at the meeting he mentioned 270 percent return. But he did mention that to him it sounds unreasonable that if, out of the seven cents, five

goes to fees and only two of them could be put at risk, or one and a half be put at risk and play with.

Very simple math would imply that you got to turn one and a half into seven. And that mathematical formula will show a 400 percent return.

So he was skeptical of that ability of having a credible investment program that produces a 400 percent return in two months, which is a thousand percent in a year, it didn't sound credible to him.

Q. Are you telling us that you believe that did not take place in the Washington National Tax meeting?

A. That what did not take place?

Q. The discussion about percentages and rate of return, and [3770] the skepticism of Mark Watson.

A. I just said it did take place.

You asked me about a document that shows a 270 percent return.

That document I've only seen once, I was preparing for the defense of this trial.

There was skepticism on the behalf of Mark Watson as to whether it is credible to have an investment program that in order to make a return, needs to generate a four or 500 percent return in two months.

MR. SCHEPER: Your Honor, transcript of November 14, 2008.

THE COURT: Give us a page.

MR. SCHEPER: I will, page 3151.

THE COURT: Line.

MR. SCHEPER: Line 8 to line 18. May I, your Honor?

THE COURT: Just give me a minute. And this is for what purpose?

MR. SCHEPER: Impeachment, your Honor.

THE COURT: Of what?

MR. SCHEPER: Of his testimony about what was said in the meeting by Mark Watson.

THE COURT: 3151 8 through 18.

MR. SCHEPER: 3151 8 through 18.

THE COURT: Is there any objection?

[3771] MR. HILLEBRECHT: I don't any inconsistency at all, Judge.

THE COURT: Sustained.

Q. Did Mark Watson talk to you in the Washington National Tax meeting about the 270 percent profit in 60 days issue?

A. As I just mentioned to you, two minutes ago, and I believe you are referring to prior testimony of mine in this case, in that meeting, there was discussion about being skeptical about the fact I got to produce returns in excess of 300 percent. It may have been 270 return, because again that number appeared in a document I've seen years later.

So I can't recall exactly what happened at that meeting. But the gist of the meeting was that it sounded to Mark Watson, and others in that meeting, in particular Mark Watson and Steve Rosenthal, that it does not sound credible to have an investment program that's objective is to generate the 400 percent return, or in your case 270 percent return -- I could take your number if you would like me to -- in a two-month period. That does not sound incredible when typically investment managers try to produce 15 percent return a year, having a program with such a high return in two months doesn't sound credible.

THE COURT: Mr. Scheper, I now find what you were referring to.

MR. SCHEPER: Thank you, sir.

[3772] Q. Were you asked any questions, or did you have anything to say about your ability to turn a profit given the amount of money you were going to be using?

"A Yes. I mean, basically, one of the people in the audience, in particular Mark Watson, figured out pretty quickly that what I am asked to do is to create a 270 percent profit in 60 days.

"He was kind of questioning how realistic, really, is it to come up with an investment program where people try and typically do not succeed to make 15 percent or 20 percent a year, yet here you have the task of making them a 300 percent in two months, how realistic is this investment program."

After Mark Watson, in that Washington National Tax meeting, challenged you on the realism of the profit potential, what did you say next?

A. As I recall how the meeting went, I said there are two elements that need to take place. One, a devaluation in which I cannot predict whether or not -- when it is going to happen. And, two, the magnitude of that devaluation. In which I have a pretty good ability to predict that number.

We then went on to say that given the devaluation, it is my belief that such a return will be achieved. Yet I cannot predict when that devaluation will happen.

So there are two elements, one is a -- one, will devaluation happen; two, given the devaluation, what types [3773] results.

I answered the second part of the question by telling him and the group of people, and Mr. Larson

and everybody, given a devaluation during the 60-day period, it would result in a return in these types of numbers of four or 500 percent return, 270, whatever, that would generate a cash-on-cash return.

Q. In responding to Mr. Watson's questions, sir, on that day, were you attempting to be accurate or were you attempting to be deceptive?

A. I believe I was accurate.

* * *

[3776]

* * *

Q. And I think, I'll try to quote you accurately, you said that Bob Pfaff told you that Larry DeLap was razor sharp, smart and honest, is that right?

A. I think more razor sharp -- I think I referred more to razor sharp, honest. He may have said that he is very smart as well, but he was talking about his very high ethical standards. That was my understanding when Mr. Larson described DeLap to me.

THE COURT: Did you know Mr. DeLap?

THE WITNESS: No, I never communicated with Mr. DeLap. [3777] I didn't know.

Q. When Mr. Pfaff and/or Mr. Larson described Larry DeLap in such terms to you, ethically devout fellow, do you remember whether that was before or after Dallas?

A. I don't remember that name coming up before -- I remember the name coming up during the approval process of BLIPS. I remember the name coming up as opposed to him being independent. There is the three groups, there is the group of naysayers, PFP, there is National Washington that have more incentive to say

no because their compensation is not related to that. And there is Larry DeLap, who is basically on his own, who could strike anything, basically kill anything he wants to at the time. That was my understanding of the different groups at KPMG.

* * *

[3786]

* * *

Q. And you also want something else from the government, isn't that right, something else from the government at sentence? Isn't there something else you want?

A. If I understand your question correctly --

Q. -- and I am not trying to confuse you.

A. Then the amen that you said, it actually has a term and that amen is a letter, I think it is called 5K. That's the version of amen that I would hope the government to provide the Judge, in which they will ask for leniency in my sentencing.

Q. If you get a sentence, if you get a sentence, whatever it [3787] is, you don't want to serve that sentence in an American jail, do you?

A. If I get a sentence, I would not -- A, I would not want to go to jail. And, B, if I go to jail, I'd rather be in a jail closer to where my family is, so they could visit me.

Q. Is the answer --

THE COURT: -- you just went right over his answer. Finish your answer.

THE WITNESS: I finished, sir, I think.

THE COURT: Nobody could hear it.

THE WITNESS: Two parts. Number one, I would rather not go to jail. And, number 2, if I do go to jail, I would rather go to jail in a country where I have family so that people could actually visit me, so I could get normal visitation rights.

Q. So is the answer to my question, you don't want to serve any sentence you get, if you get one, in an American jail?

A. That is correct.

Q. That's all I was asking.

A. So this is my answer.

Q. You don't want to serve that sentence eight thousand miles away from your family, do you?

A. I'd rather not, no, sir.

Q. You want the government to help you serve that sentence in Israel, isn't that right?

[3788] A. I would like that, sir, yes.

THE COURT: I think we covered this subject.

Q. Where your wife and your children are –

THE COURT: – I think we did cover the subject, Mr. Hoffinger. We have covered the subject.

MR. HOFFINGER: Then I have only one question left, Judge.

Q. Look, Mr. Makov, the bottom line to all of this, we're asking you is this, you are hoping to go home, if they don't, isn't that right?

A. There is no connection between me going home and the results of this trial.

MR. HOFFINGER: Thank you. That's all.

THE COURT: Thank you.

Mr. Strassberg.

MR. STRASSBERG: No questions.

THE COURT: Thank you. Redirect?

MR. HILLEBRECHT: Yes, sir.

REDIRECT EXAMINATION

BY MR. HILLEBRECHT:

Q. Afternoon, sir.

A. Good afternoon, sir.

Q. When Mr. Hagemann was questioning you yesterday, he showed you a number of documents, some of them authored by you, that talked about the ability to make a profit, the pegged currency [3789] would devalue in the future. Do you remember those documents?

A. Yes, many such documents.

Q. At any time in 1999 did you believe that the Argentine peso was going to break its peg in any given 60-day period?

A. No.

Q. Did you discuss that with John Larson?

A. Yes.

Q. What did you tell him about that?

A. That the odds of that ever happening, that the peg actually breaking within a 60-day period in '99, especially given IMF support to Argentina, which happened that year, is close to zero, it is null.

Q. Just so we are clear, IMF mean was?

A. International Monetary Fund.

Q. And did you discuss that same issue with Mr. Pfaff in 1999?

A. It -- yes, in global terms I basically, in a 60-day period, no. It will be unbelievable miracle if that event actually happens.

* * *

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK
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UNITED STATES OF AMERICA,

v. RS1 05 CR 888 (LAK)

JOHN LARSON,
ROBERT PFAFF,
RAYMOND J. RUBLE,
also known as "R.J. Ruble,"
and DAVID GREENBERG

Defendants.
----------x

New York, NY
November 25, 2008

* * *

[4120]

MR. ABRAMS: All right. Your Honor, with respect to the sufficiency of the proof as to Mr. Ruble, essentially –

THE COURT: I'm sorry, the sufficiency --

MR. ABRAMS: Of the proof in general as to Mr. Ruble. And I think, your Honor, what I'd like to do, in my brief I think the next issues that I addressed had to do with economic substance, which I believe some of the other defendants are going to be addressing, except there's the threshold legal issue as to what the standard is that's applied. Do you want to hear argument on that now or is that something that you'd like to address separately, your Honor?

THE COURT: I think I'm not going to deal with that now. My thinking on it is that the defendants, given the uncertainty among the circuits, if nothing else, are entitled to quite a favorable charge on this. And I'm inclined to charge that the test is the disjunctive test. In other words, the government will have to prove beyond a reasonable doubt both that there was no nontax reason and that as a matter of fact there was no chance, come back to that, of a profit on the deal.

I'm leaning to the view that the appropriate charge [4121] will be no reasonable chance. And I haven't come to rest in my mind about what, if anything, to say about what exactly the jury should look at in making the economic substance assessment. And I'm not sure that it's necessarily the same for all of the shelters.

It certainly seems that in the BLIPS context, it may be that the pivotal question will be whether there's a sufficiently close relationship, however that's defined, between the premium loan and the currency investment. I'm not sure that really fits the SOS transactions or FLIP OPIS, which may get a different treatment slightly. But those are my thoughts at the moment.

I'm certainly not, before I come to a definitive view on this, going to dismiss anybody on the ground that the proof is insufficient, unless it's clear that the person would be entitled to dismissal no matter how I resolved the uncertainties in my mind about what the charge ought to look like that I've identified for you.

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UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

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UNITED STATES OF AMERICA,

v. RS1 05 CR 888 (LAK)

JOHN LARSON,
ROBERT PFAFF,
RAYMOND J. RUBLE,
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Defendants.

----------x

New York, NY
December 2, 2008

* * *

[4401]

* * *

MR. DOWNING: * * *

At the end of the day, it is the substance of what occurred here, not the form that gets followed, and that if in fact we show to a jury, and the jury believes beyond a [4402] reasonable doubt, that these transactions were a sham, that part two is we have to show that Mr. Greenberg knew they were a sham. So we agree with that analysis.

THE COURT: OK. I am not, at least at this juncture, persuaded by the 2(b) argument. So to that extent, at least for now, the motion is denied. Imaginative as it is. And I am reserving decision on

the economic substance point. I will try to rule on it by Wednesday, but I am not sure I am going to be able to.

MR. STRASSBERG: Thank you, Judge. I appreciate the effort. Obviously, we are moving ahead, but any direction from your Honor would be much appreciated.

THE COURT: I am very mindful that a lot has to happen between now and next Monday. I have everybody's weekend in mind. If I am going to decide that it shouldn't go to the jury in advance of the case being summed up, I really should do it as early as I can, but all I can promise is to do the best I can. I do not find this an easy question.

* * *

[4404]

* * *

MR. ABRAMS: Yes, your Honor. On behalf of Mr. Ruble, we would reassert at this time the grounds that we previously stated both in our written motion and orally for judgment of [4405] acquittal. Candidly, your Honor, I don't think there are any new grounds that have arisen as a result of the defense case.

We received the government's letter concerning the economic substance standards, which obviously have some overlap both as to the motion and as to the charge. So I am not sure if you want to address those now.

THE COURT: Well, in general we are going to save that for the charge conference, the BLIPS counts and I guess there is one FLIP/OPIS count. Unless there is something brand new to say about that, they are going to the jury.

* * *

[4418]

* * *

Ms. GARNETT: * * *

[4419]

* * *

Mr. Ruble's involvement, as he described to himself, to his own managing partner about his extensive involvement in these transactions and his own knowledge, which we think supports at least an inference by the jury that he was aware throughout the period of FLIP, OPIS, and BLIPS that there was no business purpose for doing these transactions, that they were solely tax motivated, and that the client representations and representations from Presidio -- now the Tayebi deal is not a Presidio deal -- could not be relied upon and were not reliable as to their truth. We think that that is --

THE COURT: But that wouldn't be enough alone, I think, would it, to get to the jury? Because as I conceive of it, you are going to have to prove both an awareness of a lack [4420] of a business purpose and no possibility of a return, right?

MS. GARNETT: Well, your Honor --

THE COURT: Or no reasonable possibility.

MS. GARNETT: Right. I think that it is our view that when you look at the evidence as a whole related to Mr. Ruble's involvement in these transactions, we don't think -- we certainly think that a jury could reasonably draw the inference that Mr. Ruble knows when he is preparing these opinion letters that there

are material misrepresentations in them and that he knows there is no business purpose --

* * *

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

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UNITED STATES OF AMERICA,

v. RS1 05 CR 888 (LAK)

JOHN LARSON,
ROBERT PFAFF,
RAYMOND J. RUBLE,
also known as "R.J. Ruble,"
and DAVID GREENBERG

Defendants.

----------x

New York, NY
December 4, 2008

* * *

[4459]

* * *

MR. HAGEMANN: We would just -- again, I think my comment is that with the example the court has given, we would object to these examples as these are things that both sides can argue, but don't think --

THE COURT: I see one possible source of confusion, and the possible source of confusion is that 5 percent of $2 million in fees actually comes out to be $100,000. It happens that the postulated profit equals what Makov and Saha would have said was the expected value. So I can see that that is confusing. So I will change the assumed profit. The profit of one concerned is $50,000. I think that removes the source of potential confusion.

* * *

[4460]

* * *

THE COURT: Now you have a problem with the clarity. I know you don't like my giving an example, Mr. Hagemann. We will come back to that. But let's focus on the clarity of [4461] expression for a minute.

MR. HAGEMANN: The clarity of expression has been solved for the moment, your Honor, reserving our objection in general, ...

* * *

[4463]

* * *

THE COURT: There may be, but I never learned them in my days representing a casino.

So the third full paragraph on page 2 of BB will now read: But let me give you another example, also an example in which the taxpayer has to put up $2 million in fees. In the second example, however, assume that there is a 50 percent chance -- that is one chance out of two -- of receiving a payout of $3 million and thus a profit of $1 million within a year. Now, a 50 percent chance, or one out of two chance, of making a profit, a $1 million profit --no, just leave it as a profit – is pretty good odds, and $1 million is nothing to sneeze at even if you are very rich.

Anybody have a problem with clarity? I understand we have a conceptual problem for the defense. OK. All right.

* * *

[4464]

* * *

MR. HAGEMANN: Then just the last thing, Judge, and I think we just need to say this global. Obviously, we have asked the court to not even use the word reasonable, to say there is no possibility, but I am assuming the court has [4465] already overruled that.

THE COURT: Yes. I think in light of Gillman and other cases in the Second Circuit, Manko, reasonable is the right charge.

* * *

[4468]

* * *

MR. ABRAMS: I think that is why our feeling about the examples is it is best left for argument by both sides. You can tell the jury you can consider direct and circumstantial evidence. Let the parties argue what direct and circumstantial evidence they should consider and how they should apply it [4469] here. I think that is the fairest way to do it, your Honor.

THE COURT: To tell you the truth, Mr. Abrams, I labored over what was lines 14 to 27 on page 9 of AA for a very long time to try to make it clear and concise and worthy of publication in the Tax Lawyer or the Harvard Law Review, and I don't mean to pat myself on the back, but I think I did pretty well. Then I read it over and I said, but there is not one person on the jury who has a hope of understanding it.

My conclusion is my job is to allow the jury, as best I can do it, to apply concepts that challenge tax professors rationally, and in order for them to do it, they have to understand it.

I have simply used these examples to try to put into plain English in a way they can understand what the tax concepts are, or some of the relevant concepts. I haven't heard anything that suggests to me that the examples as corrected, and they are better thanks to the corrections, are wrong. So absent that, they stay.

MR. ABRAMS: OK. I think, your Honor, I have nothing else to say.

* * *

[4477]

* * *

Now, this brings me to the merits of the government's [4478] position. I most assuredly did not invent, for purposes of this case, the law of economic substance.

The Second Circuit cases are not without offending my brethren, colleagues, a model of entire clarity on what is required. As best I understand them, they say there is no economic substance if two things are true. Let me back up because it is even more confusing than that. As I understand the Second Circuit, the taxpayer, to sustain the deduction in a civil case has to show either that he had a nontax purpose or that there was, what I will call, real economic substance to the deal. That is, a reasonable probability of a profit exclusive of tax benefits.

Now, that's on the civil side.

This is a criminal case. The burden flips.

The government, to show that there was tax due and owing here, has to prove beyond a reasonable doubt that the taxpayer wasn't entitled to the deduction. The government must, therefore, disprove

each of the two prongs, proof of either of which by the taxpayer in a civil case, would give the taxpayer the right to the deduction. The government, therefore, in my view, and the Second Circuit, may have a chance to say something else on this subject, depending on the verdict, must prove both that the taxpayer had no nonbusiness purpose and that there was no reasonable prospect of a profit.

I hasten to add that I don't like this test, either [4479] for civil cases or criminal cases. I don't think it makes a lot of sense for a lot of reasons.

I question, although I haven't had occasion in this case to think it all the way through, whether the taxpayer's motive really ought to matter in a case like this, as opposed to the objective reality.

It doesn't make a lot of sense, in my view, for a reason that the Second Circuit has not had an opportunity to consider, and I hope it will consider, if you take the Second Circuit test literally, and just for the sake of discussion let's talk about it on the civil side, if a taxpayer goes into a shelter and winds up with a hundred million dollar tax loss, and establishes by a preponderance of the evidence, civil case now, that there was a one in a hundred chance that there would be a profit, exclusive of tax benefits, of a dollar, the taxpayer wins.

The whole concept of any rational relationship between the magnitude of the profit and the investment on the one hand, and the size of the tax deduction on the other hand, is absent.

That doesn't make any sense either. You can, I imagine, construct, I certainly couldn't, but somebody could, construct a deal that had a 50 percent chance of a one percent return on a $4 million fee, and a gigantic

tax deduction. Why should tax policy allow that deduction?

But under the law in the Second Circuit, as I [4480] understand it, seems to me the taxpayer wins that case. And, therefore, the government to win a conviction in a criminal case has to prove beyond a reasonable doubt that those circumstances are not met here.

The charge, I think I would like to be giving, would be sort of along the lines, not that I tried to polish this, of this transaction lacks economic substance if in all the circumstances there is no possibility of profit, or the possibility of profit is so small, either because it is so improbable, or because the payoff is so low, or a combination of both, that no prudent business person would do the deal except for the tax benefit.

That to me is what makes sense.

But I can't charge that in this case for two reasons, I'm bound by the precedent in this circuit, and even if I weren't, today, as to events occurring today, I don't see how I can charge in a criminal case, on a standard that, however appealing it may be to my reason, was not something of which the defendants were on fair notice at the time the conduct occurred. I can't do it.

And finally, the government's real vitriol is focused on this notion that there is something dramatically wrong in focusing on the taxpayer's intent where the taxpayer is not on trial. It is the defendants who cooked up the scheme.

The sad fact of it is, from the government's point of [4481] view, I suppose, I am not saying it is sad from my point of view, I express no opinion, but the fact of it is, that the offense charged is tax evasion. To prove tax evasion, the government's got to prove that there

was substantial additional tax due and owing, not that the defendants did something bad, but that the tax due was more than on the return.

As long as we are stuck with the test that depends on whether the taxpayer had a nontax reason as a subjective matter, the government, I think, inescapably is stuck with proving the taxpayer's state-of-mind, not mens rea, which is something else all together, but state-of-mind, in order to prove that there was a tax due and owing, in order to convict a nontaxpayer defendant of tax evasion.

Mr. Hillebrecht may not agree, you may not like it, but I thought about it.

MR. HILLEBRECHT: I know you did, Judge.

THE COURT: So the government's objections in the letter are overruled.

Is there anything else on this part?

Overruled and forgiven.

* * *

[4483]

* * *

Okay, let's go.

MR. HILLEBRECHT: Your Honor, before we move on, I am not going back -- it is not an objection or anything else, but merely a question on page 10 of AA, lines 6 to 9. You talk about, your instruction, about the focus should be on the strategy as a whole.

As I say, we are not objecting additionally to that, but I want to make certain that we are correct, that we could argue certain things in connection with that.

THE COURT: Absolutely.

MR. HILLEBRECHT: To be quite clear, we are going to –

THE COURT: – you are going to argue bank loan and that the whole thing was tacked on to this –

MR. HILLEBRECHT: – yeah.

THE COURT: No problem. No problem.

[4484] MR. HILLEBRECHT: Thanks.

THE COURT: I just think I am stuck with the strategy as a whole.

* * *

[4537]

* * *

MR. PITOFSKY: Judge, I would just like to affirm for the record, consistent with how we have been approaching this trial from the beginning, that all requests made on behalf of one defendant be deemed made on behalf of all defendants and any objections made here today or in writing by one defendant be deemed made on behalf of all defendants.

THE COURT: All objections made here today on behalf of any defendant are deemed made on behalf of all. All requested instructions discussed here today on behalf of any defendant are deemed to have been raised by all.

* * *

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

----------x

UNITED STATES OF AMERICA,

v. RS1 05 CR 888 (LAK)

JOHN LARSON,
ROBERT PFAFF,
RAYMOND J. RUBLE,
also known as "R.J. Ruble,"
and DAVID GREENBERG

Defendants.

----------x

New York, NY
December 11, 2008

* * *

[5222]

* * *

[THE COURT:]

Now, I am going to turn to the indictment. And although Count One is the conspiracy count, and all the tax evasion counts have higher numbers, I am going to talk about the tax evasion counts first.

The remaining tax evasion counts are Counts Six, Seven, Fourteen, Fifteen, Seventeen, Nineteen through Twenty-Four, Twenty-Eight, Twenty-Nine and Thirty, Thirty-Two, Thirty-Three, Thirty-Nine and Forty.

It is a crime willfully to attempt in any manner to evade or defeat any income tax imposed by law.

Each one of these counts that I've just mentioned, the ones numbered above one, charges that one or more of the defendants committed the substantive offense of tax evasion. Each count relates to a particular tax return by a particular taxpayer in a particular year. That's why there are so many numbers. Every year, every taxpayer, every return is a separate count and has to be considered separately.

Now, in view of the rulings I have made, the tax evasion counts against Messrs. Larson, Pfaff and Ruble are Fourteen, Fifteen, Seventeen, Nineteen through Twenty-Four, Twenty-Nine, Thirty, Thirty-Two and Thirty-Three.

All three of those defendants are charged on every one of those counts. Mr. Greenberg is not charged on any of them. The tax evasion counts against Mr. Greenberg are Counts Six, [5223] Seven, Twenty-Eight, Thirty-Nine and Forty.

Messrs. Larson, Pfaff and Ruble are not charged on those counts.

Now, here is where it gets even a little bit more complicated.

The government contends that one or more of defendants Larson, Pfaff and Ruble is guilty of tax evasion on each count on which they're charged, and I just gave you all the numbers, on at least one of four alternative theories. It contends that Mr. Greenberg is guilty of tax evasion on the five counts against him, on one or two of those four theories. And I will now explain all that.

The first theory applies to all of the tax evasion counts. And all of the defendants.

The first theory is that every defendant himself committed tax evasion with respect to tax allegedly

due and owing. The system of tax collection in the United States relies on the honesty of taxpayers. The law requires taxpayers to report timely, completely and honestly, income and all taxes they owe so that the government can collect the taxes due.

It is a criminal offense for a person willfully to attempt to evade income tax owed to the government, whether it is his or her own tax liability, or tax liability owed by somebody else.

Now, as I've noted, 17 of the 19 substantive counts [5224] allege evasion of taxes allegedly owed by persons other than the defendants. Two of the counts charge evasion of taxes allegedly owed respectively by Mr. Larson and Mr. Pfaff.

Now, in order to convict a defendant of tax evasion on the first of the government's theories, the government has to establish beyond a reasonable doubt, each of the following three elements with respect to the tax return in question:

The first element is that the relevant taxpayer owed substantially more federal income tax then he declared due on the income tax return for the year you are considering.

Second, that the defendant committed one or more affirmative acts of evasion described in the indictment.

Third, that the defendant acted knowingly and willfully.

Now let me explain those terms. And here is where we get to this notion of economic substance.

Remember I said the first element the government has to prove is that the taxpayer owed substantially more federal income tax than was declared on the return.

In order to prove that element in this case, we focus on the doctrine of economic substance.

In this case, the government contends that the taxpayers whose tax returns are the subject of each count of tax evasion, owed more federal income tax then they reported on the returns for one reason only, in each case the taxpayer took [5225] a deduction from his taxable income due to a loss that the tax return attributed to one of the four tax strategies at issue in this case. You remember them, FLIP, OPIS, BLIPS and SOS.

The government argues that every one of those tax strategies lacked economic substance. That the tax deduction each one of those taxpayers took was improper, for that reason, and, therefore, that each taxpayer owed more federal income tax than was declared on the tax return.

The defendants dispute that. They contend, among other things, that the tax strategies did not lack economic substance, that the deductions were proper, and that the tax returns, therefore, accurately stated the amounts of tax that were due and owing.

This means that your task here, with respect to the first element, is to decide for each count, whether the tax strategy that gave rise to the loss claimed as a deduction on that tax return, lacked economic substance in order to decide whether the relevant taxpayer owed more federal tax, income tax, than was shown that was due on the tax return.

So I am now going to instruct you with respect to your consideration of the economic substance issue.

A transaction that lacks economic substance cannot enter into tax computations. Any deduction claimed for a tax loss that allegedly was sustained in such a

transaction, therefore, is not properly claimed on a tax return.

[5226] In order to establish that a transaction lacks economic substance, the government must prove beyond a reasonable doubt both of two factors. The first factor is that the relevant taxpayer had no business purpose for engaging in the transaction apart from creating the tax deduction.

The second factor is that there was no reasonable possibility that the transaction would result in a profit.

Now, let me define one term and say a few things about each one of these factors.

First the definition. The word profit, as I use it in this context, means a return in excess of the cost of the investment, disregarding entirely any tax benefits. Let me give you an example.

If somebody puts a million dollars into a deal, he would have to get a return of more than a million dollars without considering any tax benefits in order for the transaction to be profitable. Common sense.

A return of $750,000 on a million dollar investment results in a loss of $250,000, not a profit. That's what I mean by profit. Forget the tax benefits, look at the investment and the return.

Now, let me discuss the first element that I mentioned, whether the taxpayer had any business purpose for entering into the deal.

In deciding that question, you, of course, may [5227] consider any direct evidence of the taxpayer's motive. But you are not limited to direct evidence in deciding why a taxpayer did a transaction. You can consider circumstantial evidence as well.

I am going to talk to you later about what circumst ntial evidence means. But for purposes of the present, think of it just as common sense, and then I will explain it later on.

For example, you may consider the manner in which the transaction was sold to the taxpayer. In other words, you are entitled to consider whether and to what extent it was sold to the taxpayer as a way to create a tax deduction to offset other taxable income, and/or as a way to generate a return, a profit, exclusive of tax benefits on the investment. You are entitled to consider that.

You may consider also whether a reasonable taxpayer would have paid the fees necessary to do the transaction in order to gain the chance of whatever profit potential existed if the transaction did not also carry with it tax benefits.

Now, let me try to put this into plain English.

What helped me think about it, maybe it will help you, I am going to give you a couple of examples, so bear with me on the examples.

Let's take an example in which a taxpayer has to put up $2 million to enter into some deal or strategy. Suppose [5228] further that the strategy in question offers a five percent chance, that's one chance out of 20, resulting in a payout, when all is said and done of $2,050,000. In other words, it's a one in 20 chance of making $50,000 on a $2 million investment.

Assume also that the taxpayer has a huge amount of income, and that there is a very big tax benefit to the strategy, maybe a $10 million tax loss or deduction.

Now, common sense will tell you that few, if any, people, no matter how rich they are, would put up $2 million for a five percent chance, a one out of 20 chance,

of making $50,000. So on those facts you might conclude that there must have been only one reason for the taxpayer to have paid the $2 million. And that the $10 million tax loss or deduction probably was the only reason.

Let me give you another example, also an example in which the same taxpayer has to put up the same $2 million. What's different in this example is this, assume there is a 33 percent chance, now it's one out of three we are talking about, of getting a payout of $3 million. And thus a profit of a million dollars within a year. Now, a 33 percent chance, a one out of three chance of making a profit, is not bad odds, it's pretty good odds. And a million dollars is nothing to sneeze at, even if you are very rich.

In this second example, the high likelihood, [5229] relatively high likelihood, and the large size of the potential profit, would be circumstances that might tend to show that the taxpayer had a nontax reason for doing the deal.

Many people might consider it a very good investment opportunity, without regard whether there was any tax benefit.

In the end, what you would do, is to consider all the evidence, direct, if there is any, and circumstantial, to decide whether the government had proved that the tax benefits were the only reason for doing the deal.

Those are my examples.

So let me come back to this case.

If you find that the government has proved that the tax benefits were the only reason for doing the deal involved in any particular count, you will go on to consider the second part of the economic substance test

that I gave you a moment ago. And that I am going to talk about more in a minute.

If you find, however, that the government has not proved that the tax benefits were the only reason for doing the deal, you must reject the government's economic substance argument. And you, therefore, must reject its contention that there was additional tax due and owing. That in turn would require you to find the defendant or defendants in question, not guilty on the particular tax evasion count that related to the particular taxpayer and year in question.

Now, let me say a word about the second fact in the [5230] economic substance test, which is whether there was a reasonable possibility that the strategy involved on the count you are considering would result in a profit.

Now, at one level this is largely self-explanatory, but I want to emphasize to you that this factor requires you to come to an objective judgment about whether the government has proved that there was no reasonable possibility that the strategy would result in a profit. In other words, this doesn't depend on what the taxpayer believed about the tax potential – excuse me, the profit potential – it requires you to consider all the evidence that you have, and reach a conclusion about whether the government has proved beyond a reasonable doubt, that there was no reasonable possibility of a profit.

In doing this, you are going to have to consider the evidence concerning investment aspects of each of the four tax strategies at issue in this case. For example, the transactions involving the Argentine peso and the Hong Kong dollar that were involved in the BLIPS strategy, and the foreign currency options that were

involved in the SOS strategy. Of course, you have to consider the particulars of the other two strategies, as well, I mentioned those because they come immediately to mind.

Now, in considering whether the government has met its burden on the second factor, you should take into account [5231] whether the taxpayer, considering all the aspects of the strategy, had any reasonable chance of making a profit or suffering a loss as a result of changes in the market.

To take one example, if you are considering a BLIPS deal, you should consider whether the taxpayer had any reasonable chance of making a profit or suffering a loss as a result of changes in the value of the Argentine peso and the Hong Kong dollar, given the terms of the deal.

If you find that the government has proved beyond a reasonable doubt both prongs of the economic substance test, in other words, both that the taxpayer had no nontax reason for doing the deals on the count in question, and that there was no reasonable possibility of making a profit, you may find that the requirement of additional tax due and owing will have been satisfied, and you will go on to consider whether the government has proved that the additional tax due and owing was substantial.

If you do not find that both factors of the economic substance test have been proved beyond a reasonable doubt, then the government will not have proved that additional tax was due and owing, and you must find that the defendant or defendants who are charged on the relevant count not guilty.

In this case the strategies at issue, OPIS, FLIP, BLIPS and SOS, each consisted of more than one

specific transaction, referred to them loosely as transactions, but they [5232] were actually bundles of transactions. In determining whether the taxpayer you are considering improperly deducted the loss attributed to the relevant strategy, and thus whether the taxpayer actually owed more tax than reported on your tax return, your focus should be on the strategy as a whole.

Now, as I said a second ago, if you find beyond a reasonable doubt, based on all the evidence, if the taxpayer owed more tax for the year in question then was declared on the tax return, then you must consider whether there was a substantial additional amount of tax due.

The government does not have to prove the exact amount a taxpayer owed or that all of the tax charged in a particular count was evaded. In the context of this case, it must prove beyond a reasonable doubt only that the relevant taxpayer took a deduction, that resulted from a relevant strategy that lacked economic substance, as I defined that term, and that the amount by which the taxpayer thereby understated the tax due and owing on the return was substantial.

Substantiality is not measured in terms of any particular percentage of the tax shown, shown to be due and/or payable. All of the circumstances need to be taken into consideration. A few thousand dollars of additional tax due in a given case may not be considered substantial depending on the circumstances of the case.

* * *

No. 10-1049

In the Supreme Court of the United States

JOHN LARSON AND ROBERT PFAFF, PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

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QUESTIONS PRESENTED

1. Whether the court of appeals correctly held that any ambiguity in the application of the "economic substance" doctrine did not negate the jury's finding that petitioners acted willfully in committing tax evasion.

2. Whether the court of appeals correctly held that 26 U.S.C. 7201, which provides that "[a]ny person who willfully attempts in any manner to evade or defeat any tax * * * [is] guilty of a felony," may be applied to petitioners because they assisted third-party taxpayers in filing false tax returns.

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26 U.S.C. 7201 . . . . . 2, 8, 9, 19

In the Supreme Court of the United States

No. 10-1049

JOHN LARSON AND ROBERT PFAFF, PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINION BELOW

The order of the court of appeals (Pet. App. 1a-10a) is not published in the Federal Reporter but is available at 407 Fed. Appx. 506.

JURISDICTION

The judgment of the court of appeals was entered on October 26, 2010. A petition for rehearing was denied on November 23, 2010 (Pet. App. 13a-14a). The petition for a writ of certiorari was filed on February 22, 2011. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

Following a jury trial in the United States District Court for the Southern District of New York, petitioners

were convicted on 12 counts of tax evasion, in violation of 26 U.S.C. 7201. The district court sentenced petitioner John Larson to a term of imprisonment of 121 months, to be followed by three years of supervised release, and the court sentenced petitioner Robert Pfaff to a term of imprisonment of 97 months, to be followed by three years of supervised release. The court of appeals affirmed. Pet. App. 1a-10a.

1. During the mid-1990s, petitioners were tax professionals at the accounting firm KPMG LLP (KPMG). In 1997, they left to establish Presidio Advisors LLC (Presidio), which purported to be an investment advisory company. Their co-defendant Raymond Ruble was a tax partner at the law firm of Brown & Wood LLP. At Presidio, petitioners designed, marketed, and implemented individual tax shelters, primarily in conjunction with KMPG on behalf of KMPG's wealthy clients. In 1998, petitioners and Ruble began developing the tax shelter at issue in this case: Bond Linked Issue Premium Structure (BLIPS). Petitioners designed and implemented BLIPS, and Ruble issued opinion letters that assisted in the operation and marketing of BLIPS. Pet. C.A. Br. 5-8; Gov't C.A. Br. 3-4, 7-9.

BLIPS was designed to look like a seven-year investment program that sought to generate high returns through the use of a particular kind of high-interest loan (called a "premium loan") and foreign currency investments. But in fact all but two of the nearly 200 BLIPS' clients exited the program within two months (and the remaining two clients exited in less than a year). All of those clients thus removed their money not long after investing it, and in the process they generated multi-million dollar paper losses—losses that the clients could use to offset other investment gains, thereby evading

the taxes due on those unrelated investments. According to the government, petitioners and their co-defendants thus designed BLIPS to generate massive, short-term tax deductions while appearing to be a profit-motivated, long-term investment program. Pet. C.A. Br. 9; Gov't C.A. Br. 4-6.

2. Specifically, BLIPS was structured as a three-stage program: Stage I lasted 60 days; Stage II lasted another 120 days; and Stage III extended through the end of the seventh year. At each stage, a client was required to contribute significantly more capital to remain invested in BLIPS. In order to participate in the program and generate a tax loss, a client followed three steps. Gov't C.A. Br. 12-31.

a. First, a client would form a single-member limited liability corporation (LLC-1), which would obtain from one of the banks working with Presidio a large non-recourse loan at a fixed rate with a seven-year term. Only clients who sought to generate a minimum tax loss of $20 million were eligible for BLIPS. Because the amount of the tax loss was tied directly to the amount of the loan, the loans at issue ranged from tens to hundreds of millions of dollars. And because each loan was non-recourse, the issuing bank was limited to seeking repayment from LLC-1, which had essentially no assets. To protect itself, the issuing bank thus would not permit LLC-1 to use or control the loan. None of the loan funds ever left the bank's control. Gov't C.A. Br. 12-15.

To generate the tax loss, LLC-1 would agree to pay the bank an abnormally high interest rate. In return, the bank would agree to extend not only the face amount of the loan, but some additional amount of money called "the loan premium." The loan premium ostensibly approximated the net present value of all the above-mar-

ket interest payments over the seven-year term of the loan. In theory, the bank would recoup its premium over time through the unusually high interest rate on the loan principal. In reality, the amount of the premium was determined by the amount of the tax loss that the client sought to generate. In the event that the loan was prepaid early (as every BLIPS loan was), the loan agreement called for a prepayment penalty to serve the same purpose. Gov't C.A. Br. 14-15.

b. Second, LLC-1 would contribute the funds from both the loan and the loan premium to LLC-2, a partnership in which LLC-1 had a 90% interest and Presidio had a 10% interest as the managing partner. As part of the transaction, LLC-2 assumed the obligation to repay the loan principal but not the loan premium. In addition to the loan funds, LLC-1 would contribute a further amount equal to 7% of the desired tax loss. That amount was paid by the client and was the client's only actual exposure to a potential loss. LLC-2 would then invest a portion of the client's cash fee in foreign currency investments. LLC-2 would not (and, indeed, could not) invest any of the loan funds, because those funds remained in the lending bank's sole control. Gov't C.A. Br. 13-15.

c. Third and finally, the client would exit BLIPS after a brief time. All but two of the nearly 200 BLIPS clients exited the program at the end of Stage I, and the two remaining clients exited before year-end to obtain the benefit of the tax loss. To exit the program, a client would direct Presidio to terminate LLC-1's participation in LLC-2 and redeem LLC-1's partnership interest. The client would then receive a "liquidating distribution" of assets, consisting of either stock or currency (depending on whether the client was seeking to offset

a capital gain or ordinary income). The distribution consisted of whatever remained of the client's seven percent cash fee, less any expenses. Gov't C.A. Br. 16-17 & n.*.

Regardless of the value of those assets, petitioners and their co-defendants claimed that the client's "basis" for tax purposes—or the starting value of LLC-1's partnership interest in LLC-2—was the amount of the loan premium. Under 26 U.S.C. 722 and 752, a taxpayer's basis in a partnership interest is equal to the value of any property and cash contributed to the partnership, less the amount of any liabilities assumed by the partnership. Petitioners and their co-defendants claimed that LLC-2 had assumed the loan principal, but not the loan premium, as a liability. On their view, that loan premium should be treated as money that LLC-1 had invested in the partnership. Because petitioners and their co-defendants took the position that the client's basis for tax purposes was the loan premium, it invariably appeared as if the client had lost many millions of dollars by investing in BLIPS: the amount of the loan premium (the client's putative investment) minus the terminating distribution from LLC-2 (the client's actual return). Gov't C.A. Br. 17-19.

3. Petitioners and their co-defendants' interpretation of the Internal Revenue Code depended on their false characterization of BLIPS as a long-term investment program that required a seven-year premium loan. As an initial matter, the three banks that made BLIPS loans required that the loans be carried on their books only for a short time period, not to exceed the end of the year. The loan funds were required to remain in accounts at the lending banks under those banks' control. The loan funds also were exchanged from dollars into Euros, in order to make it appear as if the funds would

be used for foreign currency investments. Gov't C.A. Br. 20-24.

In addition, the BLIPS investments were not designed to make a profit. Those investments were in "forward contracts" for "pegged" foreign currencies, principally the Hong Kong dollar and the Argentine peso. In essence, Presidio (as the managing partner for each LLC-2) was betting that those foreign currencies, which at the time were pegged to the American dollar would "break the peg" and devalue during the life of the forward contract. But currencies like the Hong Kong dollar and Argentine peso were then relatively stable. Indeed, Presidio chose those currencies because they had a low chance of devaluation and thus forward contracts were cheaper, which was important given the limited funds that each LLC-2 had available. The risk of devaluation was particularly low in the short term, which was the only duration of forward contract that Presidio could afford to purchase. Gov't C.A. Br. 25-30.

4. Together with co-defendant Ruble, petitioners developed and played an important role in the BLIPS program. Ruble authored more than 150 opinion letters in 1999 for BLIPS' clients, each one indicating in boilerplate language that the client had exited at or near the sixtieth day because of the investment's comparative performance. Those letters were based on a template that Ruble had created before BLIPS had any clients. Gov't C.A. Br. 16, 145. Petitioners designed and marketed BLIPS, procured the cooperation of the banks involved, charged the clients fees for participation in BLIPS, implements the actual BLIPS transactions by creating and terminating the LLCs and contracts used in the scheme, conducted the forward currency invest-

ments, and generated the loss reported by the clients on their tax returns. *Id.* at 144-145.

5. On October 17, 2005, the government charged petitioners and their co-defendants through a superseding indictment with a conspiracy to defraud the United States through the development, sale, and implementation of fraudulent tax shelters. The indictment charged petitioners with one count of conspiracy to defraud the United States, in violation of 18 U.S.C. 371; and multiple counts of tax evasion, in violation of 26 U.S.C. 7201 and 18 U.S.C. 2. On December 17, 2008, after a two-month trial, the jury acquitted petitioners of the conspiracy count but convicted them on 12 counts of tax evasion. The district court sentenced petitioner Larson to a term of imprisonment of 121 months, to be followed by three years of supervised release, and the court sentenced petitioner Pfaff to a term of imprisonment of 97 months, to be followed by three years of supervised release. Gov't C.A. Br. 2-3.

6. The court of appeals affirmed in an unpublished summary order. Pet. App. 1a-10a. As relevant here, the court held that the district court had correctly charged the jury "that a transaction lacks non-tax economic effect when there is no reasonable possibility that the transaction would result in a profit." *Id.* at 4a (internal quotation marks omitted). The court recognized that it had "in the past affirmed jury instructions stating a narrower definition," *ibid* (citing *United States* v. *Atkins*, 869 F.2d 135, 140 (2d Cir.) (upholding instruction that transaction has no non-tax economic effect if it is "subject to no market risk"), cert. denied, 493 U.S. 818 (1989)), but the court likewise recognized that "[it had] not held that those instructions state the outer limits of the economic substance doctrine," *ibid.*

Applying that test, the court of appeals held that "[t]he evidence was sufficient to support the convictions." Pet. App. 4a. The court found "sufficient evidence that the transaction lacked any non-tax economic effect," because "[t]estimony described the chances of profiting from the investments as 'basically zero.'" *Id.* at 5a. The court noted that "[c]lients testified that the transactions were marketed solely as tax-avoidance schemes, and that, as clients, they had no non-tax business purpose in executing them." *Ibid.* The court concluded that "BLIPS was designed, marketed, and executed as a tax shelter; and the jury was warranted in concluding that all parties knew BLIPS' profit potential to be nothing more than a pretext." *Ibid.*

The court of appeals rejected petitioners' argument that "'economic substance' law was too vague to support their convictions" and "was not sufficiently 'knowable.'" Pet. App. 5a. The court held that "'knowability,' except perhaps as probative of a defendant's subjective belief in the lawfulness of his conduct, is only relevant insofar as it bears on constitutional vagueness." *Id.* at 5a-6a. According to the court, "[v]agueness of the law does not *ipso facto* negate a jury finding of willfulness." *Id.* at 6a. (citing *United States* v. *Ingredient Tech. Corp.*, 698 F.2d 88, 97 (2d Cir.), cert. denied, 462 U.S. 1131 (1983)). The court further held that economic substance law is not only sufficiently clear for constitutional purposes, but "has been applied in criminal cases before" and "is not unsettled in the way" that petitioners contended. *Ibid.*

Finally, the court of appeals disagreed with petitioners' claim that "[their] actions fall outside the ambit of the tax evasion statute, 26 U.S.C. § 7201," because they had helped others evade taxes rather than evading their own taxes. Pet. App. 6a. Section 7201 applies to "[a]ny

person who willfully attempts in any manner to evade or defeat any tax," and the court observed that "[t]he statute's expansive language is not susceptible to [petitioners' proposed] limitation." *Id.* at 6a-7a. The court also noted that "[n]o case interpreting [Section] 7201 appears to have adopted any limit to its reach," and to the contrary "those cases that have considered [Section] 7201's scope have rather expressed it expansively." *Id.* at 7a. The court concluded that petitioners had "involved themselves, with the requisite intent, in a scheme to avoid taxes," and the court found "no statutory basis for excluding [them] from liability under [Section] 7201." *Ibid.*

ARGUMENT

Petitioners claim that this Court should grant certiorari to determine whether the court of appeals correctly held that (1) any ambiguity in the application of the "economic substance" doctrine does not negate the jury's finding that petitioners acted willfully in committing tax evasion (Pet. 13-27), and (2) petitioners violated the federal tax evasion statute, 26 U.S.C. 7201, by assisting third-party taxpayers in filing false tax returns (Pet. 27-30). With respect to both claims, the unpublished decision below is correct and does not conflict with any decision of this Court. In addition, the first claim does not implicate a circuit conflict warranting this Court's review, and the second claim does not implicate any circuit conflict at all. Further review is not warranted.

1. a. It is well-settled that a defendant convicted of tax evasion must have "willfully" attempted to evade a tax that is due, and "willfulness" in this context means a "voluntary, intentional violation of a known legal duty." *Cheek* v. *United States*, 498 U.S. 192, 199, 201

(1991). As the court of appeals concluded, objective uncertainty in the law does not necessarily undermine a jury's finding that the defendant acted willfully. See Pet. App. 5a-6a. The Second Circuit first applied that standard in *United States* v. *Ingredient Technology Corp.*, 698 F.2d 88, cert. denied, 462 U.S. 1131 (1983). In that case, the defendants argued that their convictions should have been vacated because of the exclusion of expert testimony and omission of jury instructions on the terms of a treasury regulation, which they said thwarted their defense that the applicable tax law did not provide "a clear and definite statement of the conduct proscribed." *Id.* at 96 (citation and internal quotation marks omitted). The court held that any ambiguity in the tax law was irrelevant unless that ambiguity had an effect on the defendants' subjective beliefs. *Id.* at 97.[1]

The Fifth and Sixth Circuits also have adopted that rule. See *United States* v. *Burton*, 737 F.2d 439, 444 (5th Cir. 1984) (holding that at least absent such a high degree of legal uncertainty as to "approach[] legal vagueness," "[e]vidence of legal uncertainty, except as it relates to defendant's effort to show the source of his state of mind, need not be received"); *United States* v. *Curtis*, 782 F.2d 593, 599 (6th Cir. 1986) (holding that

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[1] Contrary to petitioners' contention (Pet 18), the Second Circuit's decision in *United States* v. *Pirro*, 212 F.3d 86 (2000), does not conflict with *Ingredient Technology*. *Pirro* affirmed the dismissal of a portion of an indictment not because the legal duty was ambiguous, but because that part of the indictment did not charge a violation of any legal duty and failed to allege the essential facts of the offense. See *id.* at 91, 95. Even if there were any tension between *Pirro* and *Ingredient Technology*, this Court does not sit to resolve intra-circuit conflicts. See *Wisniewski* v. *United States*, 353 U.S. 901, 902 (1957) (per curiam).

evidence of uncertainty in the law is irrelevant unless the ambiguity affected a defendant's subjective belief about the legality of his conduct).

As those courts have recognized, willfulness "relates to the defendant's state of mind," and evidence that a defendant acted willfully must normally be negated by evidence that the defendant subjectively believed that his conduct was lawful. *Curtis*, 782 F.2d at 599.

The requirement that a defendant act willfully is intended to protect from criminal prosecution the ordinary taxpayer who mistakenly believes that his conduct was lawful; it is not intended to protect a defendant who intentionally attempts to exploit a supposed ambiguity in the tax laws. See, *e.g.*, *Sanders* v. *Freeman*, 221 F.3d 846, 855-856 (6th Cir.) ("[The defendant] chose to risk prosecution for tax evasion in exchange for greater profits. That his attempt to exploit the ambiguity in the tax laws failed is not a basis for granting relief."), cert. denied, 531 U.S. 1014 (2000). Petitioners were not innocent victims of a confusing law, and the jury reasonably concluded that they subjectively believed that the BLIPS program was an illegal tax shelter.

b. Petitioners contend (Pet. 13-20) that the decision below conflicts with decisions of the Fourth, Seventh, Ninth, and Eleventh Circuits holding that objective uncertainty in the tax law precludes a finding of willfulness.[2] That conflict is more apparent than real, and

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[2] Petitioners contend (Pet. 14) that the purported conflict arose as a result of this Court's decision in *James* v. *United States*, 366 U.S. 213 (1966), in which the Court reviewed a conviction for failing to report income from embezzled funds. In an earlier decision, *Commissioner* v. *Wilcox*, 327 U.S. 404 (1946), the Court had held that embezzled money does not constitute income to the embezzler. In *James*, the Court overruled *Wilcox* but nonetheless reversed the conviction. Petitioners are

none of the cases cited by petitioners precludes the conviction of a defendant who is aware of a legal duty and who voluntarily and intentionally violates it.

In *United States* v. *Critzer*, 498 F.2d 1160 (4th Cir. 1974), the defendant was a member of an Indian tribe and she had been advised by the Bureau of Indian Affairs that income derived from her property located on an Indian reservation was not taxable. She nevertheless was charged with failing to report income derived from that property on her federal income tax returns. *Id.* at 1160-1161. Although the court stated that the defendant's "obligation to pay [was] so problematical that [her] actual intent [was] irrelevant," *id.* at 1162, it was clear that the defendant, unlike petitioners, subjectively believed that her income was not taxable based on the advice that she had received from the Bureau of Indian Affairs. *Id.* at 1161 (noting the "undisputed" record that the "local superintendent of the Bureau of Indian Affairs" advised the defendant "that she was not taxable for rental income from her possessory interest in [Eastern Cherokee] band property").

The decision in *United States* v. *Heller*, 830 F.2d 150 (11th Cir. 1987), also provides no support for petitioners'

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correct that no position commanded a majority in *James*, but only three Justices took the position that ambiguity in the tax laws requires dismissal of criminal tax charges, even if the defendant subjectively believed that his conduct was unlawful. *James*, 366 U.S. at 221-222 (plurality opinion). This Court has subsequently characterized *James* as holding simply that "[t]he requirement of an offense committed 'willfully' is not met * * * if a taxpayer has relied in good faith on a prior decision of this Court." *United States* v. *Bishop*, 412 U.S. 346, 361 (1973). That holding does not bear on this case, because the jury reasonably concluded that petitioners subjectively believed their conduct to be unlawful, and no prior decision of this (or any other) Court validated their conduct.

position. In *Heller*, the Eleventh Circuit vacated the defendant's conviction for tax evasion, because the defendant claimed to have used a particular accounting method—"case-closed" accounting—that had been held lawful in a Tax Court decision. *Id.* at 154. The Eleventh Circuit held that the jury should have been instructed that, if the defendant had in fact used case-closed accounting, he had not acted with the requisite willfulness. *Id.* at 155. But *Heller* proceeded on the assumption that the defendant potentially had acted in good-faith reliance on legal authority. *Id.* at 154-155. Here, petitioners can make no such claim, and they point to no authority purporting to uphold BLIPS. To the contrary, as the jury reasonably concluded, petitioners subjectively believed their conduct to be unlawful. *Heller* did not hold that a defendant who correctly believes his conduct to be unlawful can escape liability by claiming that the relevant tax law was ambiguous.

The other cases on which petitioners rely (Pet. 16-17), although they contain language stating that a defendant does not act willfully when the underlying tax law is objectively unclear, also held that the tax obligations in those cases were so unclear as to be unconstitutionally vague in violation of the Fifth Amendment. In *United States* v. *Mallas*, 762 F.2d 361 (1985), the Fourth Circuit reversed the defendants' convictions for tax evasion in a case where Treasury regulations did not clearly resolve the highly technical tax liability question at issue. *Id.* at 363. The court explained that both the government and the defendant had advanced plausible interpretations of whether the claimed deductions were allowable, *id.* at 364, and concluded that the defendants

therefore lacked "fair warning" that their conduct was unlawful, *id.* at 364-365.[3]

And in *United States* v. *Dahlstrom*, 713 F.2d 1423 (1983), cert. denied, 466 U.S. 980 (1984), the Ninth Circuit concluded that the convictions of several defendants who had promoted the use of foreign trusts as a means of sheltering income could not withstand a sufficiency challenge because "the legality of the tax shelter program * * * was completely unsettled by any clearly relevant precedent on the dates alleged in the indictment." *Id.* at 1425-1428. The Ninth Circuit later clarified that *Dahlstrom*'s holding was based on the premise that the "unsettled nature" of the tax shelter scheme denied the defendants "fair notice" under the Fifth Amendment that their conduct was unlawful, as well as made it "impossible for the defendants to have a specific intent to 'willfully' violate" federal tax law. *United States* v. *Solomon*, 825 F.2d 1292, 1297 (1987), cert. denied, 484 U.S. 1046 (1988). The Ninth Circuit now treats the "willfulness" inquiry as coextensive with the due process vagueness inquiry. See *United States* v. *George*, 420 F.3d 991, 995 (2005) (citing the willfulness standard and then stating: "Without sufficient clarity in the law, taxpayers lack the 'fair notice' demanded by due process so that they may conform their conduct to the law").[4]

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[3] Similarly, in *United States* v. *Harris*, 942 F.2d 1125 (1991), the Seventh Circuit held that the defendants had "no fair warning" that failing to report as income money given to them by a wealthy widower, which they believed to be a gift, would subject them to criminal liability. *Id.* at 1127-1128. The Seventh Circuit specifically stated that its rule was "based on the Constitution's requirement of due process." *Id.* at 1131.

[4] Petitioners note (Pet. 14) that the government filed a petition for a writ of certiorari in *Dahlstrom* seeking resolution of "[w]hether, in a

The due process holdings of those cases demonstrate that they do not present a true conflict with the court of appeals' decision in this case. None of the cases cited by petitioners rests purely on a holding that ambiguity in the law precludes a statutory finding of willfulness, and given the court of appeals' acknowledgment that ambiguity in the tax law would be relevant "insofar as it bears on constitutional vagueness," there is no reason to believe that any of those other cases would have been decided differently in the Second Circuit. Pet. App. 5a-6a. Petitioners have never contended that the economic substance doctrine is so vague that their convictions amount to a due process violation, and the conflict that petitioners identify is therefore more apparent than real. This Court's intervention is not warranted.

c. Even if there were a conflict among the courts of appeals on the question of whether objective uncertainty in the tax law precludes a jury from finding that a defendant acted willfully in evading taxes, this case presents a poor vehicle to resolve that conflict because the parameters of the economic substance doctrine were not objectively unknowable to petitioners. Moreover, petitioners have not demonstrated that the loan-premium transactions had economic substance under any test.

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prosecution of promoters of an unlawful 'tax shelter' program, the absence of a prior statute, regulation, or court decision directly establishing the illegality of the scheme precludes a finding of willfulness as a matter of law." Pet. at I, *Dahlstrom*, *supra* (No. 83-1297). This Court denied the petition, 466 U.S. 980 (1984), and subsequent decisions have made clear that the Ninth Circuit considers ambiguity relevant only to the extent that it renders the law unconstitutionally vague. Petitioners do not contend that the circuits remain in conflict on the specific question presented in *Dahlstrom*.

It is well-settled that a financial transaction may be disregarded for tax purposes if it lacks "economic substance." See, *e.g.*, *Nebraska Dep't of Revenue* v. *Loewenstein*, 513 U.S. 123, 133-134 (1994); *Frank Lyon Co.* v. *United States*, 435 U.S. 561, 576-580 (1978); *Lee* v. *Commissioner*, 155 F.3d 584, 586 (2d Cir. 1998); *James* v. *Commissioner*, 899 F.2d 905, 908 (10th Cir. 1990); *Kirchman* v. *Commissioner*, 862 F.2d 1486, 1492 (11th Cir. 1989). The test that is widely used among the courts of appeals to determine whether a transaction lacks economic substance asks (1) whether the taxpayer was motivated by a business purpose other than obtaining income tax benefits, and (2) whether there is a reasonable possibility that the transaction would result in a profit. *Rice's Toyota World, Inc.* v. *Commissioner*, 752 F.2d 89, 91 (4th Cir. 1985); see also *ACM P'ship* v. *Commissioner*, 157 F.3d 231, 247 (3d Cir. 1998), cert. denied, 526 U.S. 1017 (1999); *Casebeer* v. *Commissioner*, 909 F.2d 1360, 1363 (9th Cir. 1990). Petitioners repeatedly endorsed that formulation of the economic substance doctrine in pretrial filings. Gov't C.A. Br. 70, 113-114.

Furthermore, the opinion letters that were produced and marketed as part of the BLIPS scheme demonstrate that the economic substance doctrine was well-defined and objectively knowable at the time of petitioners' conduct. The opinion letters discussed the relevant case law and concluded that there had to be a "reasonable possibility of profit" for the transaction to have economic substance. Gov't C.A. Br. 112. Ruble's opinion letters framed the key economic substance question as whether the taxpayer has "a *reasonable possibility* of economically benefitting from the transaction without regard to tax benefits," *id.* at 81, and the KPMG opinion

letter states that "the case law applying the business purpose/economic substance doctrine *consistently*" requires "a *reasonable potential* for making a pre-tax profit," *ibid.*

Although petitioners evidently had a clear understanding of what the economic substance doctrine required in the opinion letters and during pretrial proceedings, petitioners later requested a jury instruction stating that a financial transaction lacks economic substance if it involves "no possibility" of making a profit. Gov't C.A. Br. 66-67; Pet. 8. Petitioners now change their formulation again, contending that the economic substance of BLIPS was reasonably debatable because some courts require only that the transaction have "any practical economic effects other than the creation of income tax losses." Pet. 24 (citation omitted).

Petitioners fail to explain, however, how their proposed any-practical-economic-effects test is functionally different from the reasonable-possibility-of-profit test articulated in their opinion letters and by the court of appeals. Nor do petitioners explain how the BLIPS program—in which the participating banks would not permit any of the loan funds to leave the banks' control, and the transactions were not even designed to make a profit, see pp. 3-6, *supra*—had "any practical economic effect" other than to create tax losses for BLIPS' clients. Petitioners thus have not established that the loan-premium transactions at issue had economic substance under the test that they currently espouse.

Petitioners have therefore failed to show how the asserted ambiguity in the law even conceivably affected the lawfulness of petitioners' conduct: there is no reason to believe that their conduct may have been lawful under any legal standard for the economic substance

doctrine. This case therefore does not present a suitable occasion for addressing the relevance of ambiguity in the underlying tax law when the jury expressly finds that the defendant acted willfully.

d. Petitioners' further contention (Pet. 20-21) that the decision below conflicts with this Court's decision in *Safeco Insurance Co.* v. *Burr*, 551 U.S. 47 (2007) (*Safeco*), is without merit. In *Safeco*, the Court addressed a provision of the Fair Credit Reporting Act, 15 U.S.C. 1681n(a), that imposes civil liability on anyone who "willfully" fails to provide notice of certain adverse actions to consumers. The *Safeco* Court held that the provision applies to conduct undertaken in reckless disregard of the statutory notice requirement. 551 U.S. at 56-57. In reaching that conclusion, the Court explained that "where willfulness is a statutory condition of civil liability, we have generally taken it to cover not only knowing violations of a standard, but reckless ones as well." *Id.* at 57.

This Court was careful to explain in *Safeco* that its discussion of willfulness, a word "whose construction is often dependent on the context in which it appears," 551 U.S. at 57 (quoting *Bryan* v. *United States*, 524 U.S. 184, 191 (1998)), pertained only to liability under the Fair Credit Reporting Act, *id.* at 58. The Court's statement in a footnote that evidence of subjective bad faith cannot support a finding of willfulness if the defendant's reading of a statute is objectively reasonable, *id.* at 70 n.20, was informed by the Court's conclusion that "in the sphere of civil liability," recklessness entails "conduct violating an objective standard," *id.* at 68. The willfulness standard applied in *Safeco* is far different from the willfulness standard applicable to criminal tax evasion,

where "willfulness" is "the voluntary, intentional violation of a known legal duty." *Cheek*, 498 U.S. at 201.

2. Petitioners further contend (Pet. 27-30) that they could not be convicted under the federal tax evasion statute, 26 U.S.C. 7201, for helping others to evade their taxes, because that statute applies only to "acts of evasion committed by people actually involved in the filing and/or payment of the tax." Pet. 30. But as the court of appeals recognized, the text of the statute admits of no such limitation. Pet. App. 6a-7a. Section 7201 provides that "*[a]ny person* who willfully attempts *in any manner* to evade or defeat *any tax* * * * [is] guilty of a felony" (emphases added). The statute is thus drafted broadly to reach "any conduct, the likely effect of which would be to mislead or to conceal" any tax liability. *Spies* v. *United States*, 317 U.S. 492, 499 (1943). As this Court explained in *Spies*, "Congress did not define or limit the methods by which a willful attempt to defeat and evade might be accomplished and perhaps did not define lest its effort to do so result in some unexpected limitation." *Ibid.* The court of appeals correctly declined to "constrict the scope" of Section 7201, which provides that tax evasion "may be accomplished 'in any manner.'" *Ibid.*

Petitioners do not cite any authority interpreting Section 7201 to apply only to a defendant's evasion of his own tax liabilities. To the contrary, as the court of appeals noted, "those cases that have considered [Section] 7201's scope have rather expressed it expansively." Pet. App. 7a; see, *e.g.*, *United States* v. *Townsend*, 31 F.3d 262, 267 (5th Cir. 1994) ("[Section] 7201 is not limited to prosecutions of those who evade taxes that they may owe themselves, but rather it encompasses prosecutions of any person who attempts to evade the tax of any-

one."), cert. denied, 513 U.S. 1100 (1995); *Tinkoff* v. *United States*, 86 F.2d 868, 876 (7th Cir. 1936) ("Nor is it any defect that the tax attempted to be evaded was that of another. The statute is so framed as to make liable any person who attempts willfully and unlawfully to evade the tax of himself or of any other person."), cert. denied, 301 U.S. 689 (1937).

Petitioners claim that, because they were not "actually involved in the filing and/or payment of the tax," their conduct was too remote from the falsification of those returns to render them liable for tax evasion. Pet. 30. As a legal matter, it does not matter for purposes of Section 7201 whether petitioners participated in the preparation of the actual returns at issue, so long as they attempted "in any manner to evade or defeat any tax." 26 U.S.C. 7201; see, *e.g.*, *United States* v. *Doughty*, 460 F.2d 1360, 1362 (7th Cir. 1972) ("It was unnecessary for defendant's conviction of aiding and abetting that the government prove he helped prepare and file the false return. It was sufficient that he participated in the commission of the offense."); *United States* v. *Frazier*, 365 F.2d 316, 318 (6th Cir. 1966) ("[I]t was not necessary for the Government to prove that [the defendant] had anything to do with the actual preparation or filing of the income tax returns."), cert. denied, 386 U.S. 971 (1967).

As a factual matter, there was sufficient evidence introduced at trial that petitioners had assisted BLIPS' clients in evading their tax liabilities. Although petitioners did not have direct contact with BLIPS' clients, the jury reasonably concluded that their conduct was in no way remote from their tax evasion: petitioners participated in designing and marketing BLIPS, procuring the cooperation of the banks involved, charging the clients fees for participation in BLIPS, implementing the

BLIPS transactions by creating and terminating the LLCs and contracts used in the scheme, conducting the forward currency investments, and generating the loss reported by BLIPS clients on their tax returns. Petitioners' conduct was critical to the ability of Presidio and BLIPS' clients to generate nonexistent tax losses in order to evade offsetting tax liabilities.

Finally, petitioners fail to address the alternative theory submitted to the jury that they aided and abetted in the preparation of the clients' false returns under 18 U.S.C. 2. See Gov't C.A. Br. 146. The district court instructed the jury that it could find petitioners guilty as aiders and abettors if it found that (i) the taxpayer at issue had committed at least one act that would have been an affirmative act of evasion if he had acted with the willful intent to evade taxes and (ii) petitioners were a cause in fact of the taxpayer's actions or played a substantial part in bringing about or causing the taxpayer to file a false return. *Id.* at 155-156. Petitioners do not challenge those instructions before this Court.

Even assuming (incorrectly) that Section 7201 were limited to "acts of evasion committed by people actually involved in the filing and/or payment of the tax," Pet. 30, and that petitioners did not qualify under that test (despite their creation, design, and marketing of BLIPS to the taxpayers, see Gov't C.A. Br. 3-12, 150-151), any rational jury that found guilt under the government's theory of liability would also have found aiding and abetting liability. "One purpose of 18 U.S.C. § 2 is to enlarge the scope of criminal liability under existing substantive criminal laws so that a person who operates from behind the scenes may be convicted even though he is not expressly prohibited by the substantive statute from engaging in the acts made criminal by Congress." *United*

States v. *Ruffin*, 613 F.2d 408, 413 (2d Cir. 1979); see Gov't C.A. Br. 156-157. That description would cover petitioners even under their own theory of the case. Accordingly, because any rational jury that convicted petitioners would necessarily have found that petitioners played a substantial role in causing BLIPS' clients to commit affirmative acts of evasion by filing false returns, the claimed error on the scope of Section 7201 is harmless beyond a reasonable doubt. *Skilling* v. *United States*, 130 S. Ct. 2896, 2934 & n.46 (2010) (alternative theory error is subject to harmless-error analysis).

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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No. 10-1049

In the Supreme Court of the United States

JOHN LARSON AND ROBERT PFAFF,

Petitioners,

v.

THE UNITED STATES OF AMERICA,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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ARGUMENT

The opposition confirms why this Court's intervention is urgently needed. The government steadfastly ignores, but cannot deny, the great national significance of this case—"the largest criminal tax case in American history," *Stein v. KPMG, LLP*, 486 F.3d 753, 756 (2d Cir. 2007), which was built on a "fairly novel theory of criminal liability," *United States v. Stein*, 541 F.3d 130, 157 (2d Cir. 2008), and on the most infamous abuse of prosecutorial power in recent memory. The opposition forthrightly embraces the Second Circuit's misguided and dangerous holding that a defendant can "willfully" violate tax obligations even when those obligations are ambiguous and the defendant's conduct was objectively reasonable. The government's efforts to minimize the square circuit split on that issue—which the United States previously has asked this Court to resolve—are half-hearted and unpersuasive. And the government does not even attempt to deny that its boundless interpretation of 26 U.S.C. §7201 destroys Congress's carefully gradated system of tax offenses.

1. The government endorses the Second Circuit's reasoning and contends that any person "who intentionally attempts to exploit a supposed ambiguity in the tax laws" is a felon—even if the law *was* ambiguous and his interpretation was objectively reasonable—if a jury finds that he subjectively did not believe his position would or should ultimately prevail. Opp.11. The government argues that the five Justices who concluded otherwise in *James v. United States*,

366 U.S. 213 (1961), were wrong,[1] and that this Court's recent unanimous contrary holding in *Safeco Insurance Co v. Burr*, 551 U.S. 47, 70 n.20 (2007), must be confined (bizarrely) to the civil context.

The government's candor about the radical theory underlying this prosecution crystallizes the issues for this Court and demonstrates why review is necessary. As a statutory matter, the government's position is obviously untenable. Taxpayers are immune from all civil penalties when there is, objectively, "substantial authority" supporting their positions—regardless of state of mind. Treas. Reg. §1.6662-4(d)(2). The only court that has ever considered BLIPS in a civil context concluded that no penalties could be imposed because of that rule. Pet.13. So the government's position is that Congress intended to immunize taxpayers from even modest civil penalties when their conduct is consistent with an objectively reasonable understanding of the law—but intended to send those same taxpayers (and anyone else, like petitioners, who has *any* connection to the transaction) to jail for the same conduct. And the government thinks that citizens are given fair warning of that absurd and counter-intuitive rule, notwithstanding the rule of lenity, solely by the word "willfully"—which the government concedes can have many meanings. Opp.18.

Counsel are aware of no Supreme Court precedent for punishing violations of objectively unclear legal

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[1] Justices Black and Douglas agreed with the plurality that the defendants were entitled to acquittal because of the ambiguity. *See id.* at 224 (Black, J., concurring in part and dissenting in part); *United States v. Critzer*, 498 F.2d 1160, 1163 n.5 (4th Cir. 1974).

duties. The whole purpose of the rule of lenity is to make such prosecutions impossible.

The government concedes that its position is inconsistent with *Safeco*, but contends that *Safeco*'s unanimous holding should be limited to cases involving *civil* penalties imposed under a recklessness standard—which, the government says, is "objective," whereas willfulness is "'the voluntary, intentional violation of a known legal duty.'" Opp.18-19 (quoting *Cheek v. United States*, 498 U.S. 192, 201 (1991)). But as Judge Wilkinson explained in *United States v. Mallas*, a "'voluntary intentional violation of a known duty,' requires that the duty involved must be *knowable*." 762 F.2d 361, 363 (4th Cir. 1985) (emphasis added). This Court has held in other contexts that that a defendant cannot "fairly be said to 'know' that the law forbade conduct" where the conduct was "objective[ly] reasonable[] ... as measured by reference to clearly established law." *Harlow v. Fitzgerald*, 457 U.S. 800, 818-19 (1982).

This Court held in *Cheek* that the unusual vagueness of the tax laws required a new subjective good-faith defense even for objectively *un*reasonable conduct, but gave no hint that it intended thereby to criminalize objectively *reasonable* conduct for the first time. *Safeco* certainly provides no support for the government's spurious distinction. This Court reasoned that "Congress could not have intended" penalties for willfulness "for those who followed an interpretation that could reasonably have found support in the courts." 551 U.S. at 70 n.20. That inference is vastly stronger here—where severe *criminal* penalties are at issue and the "substantial

authority" defense expressly precludes even a modest civil penalty.

2. The government concedes that the Second, Fifth, and Sixth Circuits have embraced its extreme position. Opp.10. Its efforts to distinguish the cases on the other side of the split are unpersuasive.

a. The government asserts that it somehow was "clear" that the defendant in *United States v. Critzer* subjectively believed that she owed no tax. The Fourth Circuit's actual holding was that "defendant's actual intent is irrelevant." 498 F.2d 1160, 1162 (4th Cir. 1974). And any ambiguity in *Critzer* is dispelled by *Mallas*.

b. The government says that in *United States v. Heller*, 830 F.2d 150 (11th Cir. 1987), the court "proceeded on the assumption that the defendant potentially had acted in good-faith reliance on legal authority." Opp.13. Not so. *Heller* held (citing *Critzer* and *James*) that the "requisite element of intent could not be proved when the law was uncertain or cast in doubt by prior court decisions," and that a prior case supportive of the taxpayer's position "was sufficient, *as a matter of law*, to make it inappropriate to impose criminal liability for following the case-closed method" of accounting. 830 F.2d at 154-55 (emphasis added). The court remanded for a new trial under instructions requiring acquittal if the defendant used that method. The Eleventh Circuit did not suggest that the defendant had to know about the prior case, or that he might be guilty if he subjectively believed that the case-closed method was unlawful.

c. The government acknowledges that *Mallas*, *Dahlstrom*, and *United States v. Harris*, 942 F.2d 1125 (7th Cir. 1991), hold that "a defendant does not act

willfully when the underlying tax law is objectively unclear." Opp.13. The government says those cases "also held" that conviction would violate due process, and argues that the split is "more apparent than real" because petitioners have not argued that the economic substance doctrine is unconstitutionally vague. Opp.15.

The holdings of these cases are clearly statutory, not constitutional. *Mallas*, 762 F.2d at 363; *see also, e.g*, *Harris*, 942 F.2d at 1131-32 & n.6. The government certainly understood *Dahlstrom* that way when it filed a petition for certiorari telling this Court that the Ninth Circuit's reasoning "squarely conflicts with [*United States v.*] *Ingredient Technology Corp.*[, 698 F.2d 88 (2d Cir. 1983)]." *See* U.S. Pet. for Cert., No. 83-1297, *United States v. Dahlstrom* ("U.S. *Dahlstrom* Pet."), at 15; *see also id.* at 11-12 (arguing that willfulness is solely "a question of subjective intent ..., not the objective certainty or uncertainty of the law").

Contrary to the government's contention (Opp.14), subsequent Ninth Circuit cases have not renounced *Dahlstrom*'s statutory holding. The most recent decision holds that "[t]he element of willfulness cannot obtain in a criminal tax evasion case unless 'the law clearly prohibited the conduct alleged in the indictment.'" *United States v. George*, 420 F.3d 991, 995 (9th Cir. 2005) (citing *James*; other citations omitted). And *United States v. Solomon* read *Dahlstrom* as holding that "the 'unsettled legality' of the tax shelter scheme denied 'fair notice' under the fifth amendment *and made it impossible for the defendants to have a specific intent to 'willfully' violate the federal statutes*." 825 F.2d 1292, 1297 (9th Cir. 1987) (emphasis added).

The Fourth, Seventh, and Ninth Circuits' interpretation of "willfully" was informed by fair warning concerns. Petitioners similarly have always argued that the doctrine of constitutional doubt supports their interpretation. *E.g.*, Pet.15-16; Larson CA2 Br.17, 37, 56. But none of the cases suggests that the objective ambiguity that defeats statutory willfulness is coextensive with due process vagueness doctrine. The government's position is that a jury finding of subjective scienter would *cure* any due process problem, so its implication that alternative due process holdings could ameliorate or reconcile the circuit split is disingenuous. *See* U.S. *Dahlstrom* Pet. 11-12 & n.10. And the bottom line is that these three circuits reverse convictions when tax obligations are objectively unclear, and the courts on the other side of the split do not. The Second Circuit's cursory due process analysis demonstrates that constitutional vagueness doctrine does not bridge this gap. As the government concedes, the Fourth Circuit held in *Mallas* that tax defendants are entitled to acquittal if existing regulations and case law "did not clearly resolve" the issue and defendant's position was "plausible." Opp.13. That is clearly true here. The Second Circuit's opinion effectively concedes that the law was unsettled, and merely concludes (unpersuasively) that prior precedent did not quite foreclose *the government's* interpretation. Pet.26-27.

In any event, petitioners *have* argued that the economic substance doctrine is "notoriously vague," Pet.21, and, as applied here, violates due process. *E.g.*, Pfaff CA2 Br.28-29, 38-40; Larson CA2 Br.37-38; CA2 App.1854-56, 2439-43. Petitioners framed their argument primarily in statutory terms because that is

what the leading cases do, and because of this Court's preference for interpreting statutes narrowly to avoid difficult constitutional questions. *See* Pet.15-16 ("[T]here is no reason to reach difficult constitutional questions that can be avoided so easily on statutory grounds."); *Skilling v. United States*, 130 S. Ct. 2896, 2927-28 (2010). But the Second Circuit actually resolved the constitutional question, App.6a; Opp.8 (acknowledging same), and this Court certainly could reach that issue if it became important.

3. a. The government suggests that "the parameters of the economic substance doctrine were not objectively unknowable," citing carefully selected case law and the BLIPS opinion letters. Opp.15-17. The petition acknowledged that civil cases in other circuits had used a "reasonable possibility of profit" test. That is why the opinion letters addressed it. But the petition demonstrated that:

- the doctrine was and is deeply unsettled and unpredictable nationwide, and that many precedents instead analyzed whether a transaction involved *any* possibility of profit, market risk, or economic effects;
- the IRS conceded, in a formal report to Congress the very summer that KPMG was debating BLIPS, that the case law was "conflicting" and "incoherent" and that "no economic effects" was the "most prominent" standard nationwide;
- the *Second Circuit* case law prior to the charged conduct consistently used a "no economic effects" or "no market risk" standard;

- the "reasonable-possibility-of-profit" test charged here is inconsistent with this Court's actual holding in *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978); and
- the only court that has analyzed BLIPS in a civil context held that no civil penalties could be imposed because the taxpayers had objectively "substantial authority" for their position.

Pet.21-27. The government tellingly has *no* response to any of those points.

b. The opposition suggests that it is unclear how "no possibility of profit," "no market risk," and "no practical economic effects" are the same test, and how any of them differs from the "reasonable-possibility-of-profit" instruction used here.[2] The first three all capture the classic form of the economic substance doctrine, which disregards transactions that were essentially just illusory paper-shuffling that left the taxpayer's economic interests unchanged—such as the 1990s cases involving perfectly offsetting options straddles, or cases involving supposed contingencies that were actually within the taxpayer's control. That form of the doctrine is the only one supported by this Court's cases and the prior Second Circuit cases, and the only one that draws lines that are clear, objective, and predictable enough for criminal enforcement.

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[2] The government wrongly suggests that petitioners endorsed that test, Opp 16, but has not argued waiver (here or below). Though an early joint defense filing referenced that test, petitioners argued consistently that a "no-market-risk" or "no-possibility-of-profit" standard must be applied. Pet.8-9.

Petitioners would have been entitled to acquittal under any of those tests. The BLIPS currency forward contracts were real, and exposed the taxpayers to market risks and opportunities driven by geopolitical contingencies outside their control. If things had gotten worse in Argentina just a little faster, these investors would have made huge profits. The government says that "the Hong Kong dollar and Argentine peso were then relatively stable." Opp.6. But it cannot and does not deny (and therefore has conceded, *see* Sup.Ct.R. 15.2) that a devaluation was possible, that the BLIPS investors would have made very substantial profits if it happened, that the banks involved with BLIPS hedged these risks, and that Argentina's currency and economy did in fact collapse in dramatic fashion little more than a year later. Pet.2-3, 7-8. Regardless, for the willfulness issue all that matters is that application of the economic substance doctrine was *at least* ambiguous and debatable (even under the "reasonable-possibility-of-profit" test). This case therefore is a perfect vehicle to resolve the circuit split—and also to straighten out economic substance law, if this Court were so inclined.

c. The government attempts to cloud the issues presented with other arguments that it strategically abandoned below and that are now irrelevant. *See* Pet.22 n.4. It tries, for example, to suggest that these transactions were shams because most were terminated after 60 days, because the "premium" aspect of the loans was somehow illusory, or because the loan proceeds were never in the taxpayer's control. Opp.2-6. But this jury was instructed that the *only* issue was whether "there was no reasonable possibility that the transaction," considered "as a whole," "would

result in a profit." App.85a, 88a-90a; U.S. CA2 Br.129 (conceding same). The government cannot defend convictions on theories never submitted to the jury. And (giving maximum deference to the jury's verdict) the petition *accepted* the government's arguments that BLIPS should be evaluated as a 60-day transaction.

4. On the separate §7201 question, the government does not deny that the Second Circuit's limitless interpretation collapses all the different gradated tax penalties into §7201 and renders other provisions like §7206(2)—which has been used instead of §7201 in every prior tax-shelter promoter prosecution—entirely superfluous. Pet.27-28. Contrary to the government's argument, the jury did not "conclude[] that [petitioners'] conduct was in no way remote from [the BLIPS clients'] tax evasion." Opp.20. The instructions did not ask the jury to make *any* findings concerning remoteness or proximate causation (over petitioners' objection). CA2 App.2617/4496-97.

The government cites no case affirming a §7201 conviction of anyone this remote from the tax returns. It cites two aiding and abetting cases (Opp.20), but the government's expansive theory of 18 U.S.C. §2 liability here just collapses the gradated structure of tax crimes via a slightly different analytical route. Even if accepted, that alternative theory cannot save these convictions. The §2 instructions required a finding that petitioners were a "substantial" cause of the tax underpayments. Opp.21-22. A reasonable jury easily could have concluded otherwise, given how remote petitioners were from the returns and all of the independent intervening causes. The taxpayers had independent tax advisors (Pfaff CA2 Br.16-17), and independently elected to file returns claiming the

BLIPS losses—in some cases even after the IRS issued negative guidance about the transaction and KPMG warned them that the legal landscape had changed. Pet.4. So petitioners would be entitled, at a minimum, to a new trial.

5. This case is the tip of a very large iceberg. The "fairly novel theory of criminal liability" under which these defendants were convicted, *Stein*, 541 F.3d at 157, was also deployed to destroy a national law firm and to extort hundreds of millions of dollars in fines and onerous deferred prosecution agreements from the major accounting firms—which, in the immediate shadow of what happened to Arthur Andersen, knew they could never survive an indictment regardless of the merits.

The tax bar and popular press recognized immediately that this prosecution was unprecedented and overreaching. Pet.4, 21-22. Like the Andersen prosecution, it was built on a highly aggressive legal theory that criminalized conduct that was widely understood to be lawful professional practice at the time. "These cases have contributed to a seismic shift in the nature of tax practice by deterring lawyers and law firms from providing opinions for legitimate tax planning purposes." Charles A. Rose, *The Tax Lawyer's Dilemma: Recent Developments Heighten Tax Lawyer Responsibilities And Liabilities*, 2011 Colum. Bus. L. Rev. 258, 262 (2011); *see id.* at 289 ("The lack of clarity under the current legal regime, coupled with the fear of punishment, has had a significant detrimental impact on legitimate tax planning service, and has driven talented lawyers away from legitimate tax advisory services."). Lawyers often have an ethical *duty* to pursue their clients' interests within the

bounds of an objectively reasonable understanding of the law, even if the lawyer subjectively believes that the client's interpretation should be rejected. Pet.32-33. So the government's theory is a recipe for incarcerating the entire bar, as well as any citizen with the temerity to challenge the government's position on a debatable point of law.

The U.S. Attorney's Office for the Southern District of New York continues to pursue these prosecutions aggressively. Just in the past few months, it obtained the conviction of the former head of the tax practice at Jenkins & Gilchrist and extracted a deferred prosecution agreement and $554 million fine from one of the banks involved in these transactions. More broadly, federal prosecutors continue to try to fill perceived vacuums in financial and professional regulation with creative expansions of the criminal law. The Second Circuit's holding that criminally "willful" behavior can be found even when the law is objectively ambiguous facilitates that disturbing trend. It turns the rule of lenity on its head and is inconsistent with the most fundamental values of the criminal law. Conflict among the circuits should not be left unresolved on such an important issue, which establishes the line between criminal and lawful professional behavior.

CONCLUSION

The petition should be granted.

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